THE REAGAN BUDGET EXPERIENCE: LESSONS FOR THE FUTURE

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Can you think of a more discussed topic in recent years than the federal deficit? I'm sure you're getting a little tired of hearing about the problem, but I'm also sure that "not talking about it" won't help make it go away. The seriousness of the deficit is well established--it has long-run cost implications for our society. Perhaps that is the problem--the costs seem so far into the future that it appears we can get by with mere rhetoric instead of meaningful actions. After all, we've had more than six years of strong economic growth and, for the most part, inflation has not been a problem. The urgency of the deficit problem just doesn't seem to be confirmed by the short-term results.

I know that as financial professionals, and more importantly as interested citizens, you have an appreciation for the longer-run view. To avoid long-run costs, you can't wait until they become evident; you have to anticipate and plan. What I'm suggesting today is more political than economic, but carries important economic implications. What will it take for our political leaders to wake up and take action on the deficit? I don't have a solution, but I do have a suggestion that I think would nudge our lawmakers in the right direction.

To develop my point, it is necessary to provide some background--some recent economic history if you will. The perspective is simply the 1980s, or more specifically, the period from March 1981 through September 1988. Not a long period as historians might see it, but--I think--long enough to make my point.

Think back to early February 1981. Ronald Reagan had just taken office and proposed an economic plan. His general objective was to bring federal government "back into line." More specifically, his goals were "an immediate, substantial and sustained reduction in the growth of federal expenditures and a significant reduction in federal tax rates." What prompted this plan?

Allow me to refresh your memory. When Reagan took office, the U.S. economy was in a recovery phase from a short recession in the first half of 1980. As of early 1981, the recovery was proceeding slowly. Unemployment was still well above 7 percent, and productivity was actually declining. Not what you'd call your classic economic recovery! But that was only half of it. Inflation and interest rates were both in double digits. Recall that the prime rate was over 20 percent and Fed funds were trading at 19 percent. Along with all these problems, the federal budget deficit was running in the range of $55 to $60 billion, which, at that time, was considered large. Reagan described the situation as the most serious since the 1930s. Excluding wartime periods, he was probably right in this assessment.

What was the result of the Reagan administration's analysis of these problems? To put it in its simplest form, it laid the blame right at the federal government's door. President Reagan said that the government, through taxes, spending, regulatory policies and monetary policy, had sacrificed long-term growth and price stability for short-term goals.

The proposed solution followed from this analysis: restore fiscal integrity; increase incentives for saving, investment and production; obtain monetary and financial stability; and enhance the role of the marketplace as the principal force in the allocation of resources. High sounding, but, more specifically, reduce the rate at which government spending was increasing; reduce individual tax rates by 10 percent a year for 3 years starting July 1, 1981 (this was the supply side of the plan); and reduce corporate taxes by allowing for an accelerated recovery rate for machinery and equipment.

There were, of course, other important features of the program, relating primarily to regulation and monetary policy; but I want to focus on the Reagan budget, which was to show a steady move toward balance with a surplus of $22 billion by fiscal 1986. As we look back now, the budget deficit for 1986 came in at $221 billion--an error of about $240 billion. What accounted for this monstrous error? Was it because spending was not controlled as planned? Or was it that revenues were dragged down by the tax cuts that were enacted in 1981? Or was it something else?

We get an important clue by noting that most of the increase in the deficit had already occurred by 1983. The budget plan was for a deficit of $63 billion in 1983; the actual deficit for that year was $208 billion.

We can dig further by looking at the numbers behind the deficit; namely, receipts and expenditures. The Reagan plan for federal revenues was that they would be $940 billion by 1986; the actual amount collected by the government in that year was $769 billion. In other words, there was a revenue shortfall of $170 billion. This accounts for almost two-thirds of the deficit error of $243 billion.

Research at our bank shows that this revenue shortfall was attributable primarily to the recession that started in July 1981 and continued into late 1982. It was a serious recession, with unemployment rising to nearly 11 percent at the trough. The Reagan administration did not forecast this recession. They forecast strong growth and continued inflation; so even though they proposed a large tax cut, they foresaw continued strength in federal revenue. But as a result of the recession, by 1986 GNP was $820 billion short of what they forecast. With each dollar of GNP generating about 20 cents in federal revenue, this error in the GNP forecast almost fully explains the $170 billion shortfall in 1986 revenue. It's true that taxes <u>were</u> cut during this period, but research at our Bank indicates that these tax cuts were not the culprit.

How about spending? A review of the 1981 Reagan budget plan reveals that federal spending was projected at $918 billion for 1986. The actual figure came in at $990 billion, or an error of over $70 billion. Certainly not an error to be sneezed at, but relatively small compared with the $170 billion error in forecasting revenues. Thus pausing at this point, it appears that the cause of the deficit can be traced to (1) a large forecast error for GNP and (2) an underestimate of federal spending.

But that's not the end of the story. Let's take a closer look at federal spending. What was the source of the $70 billion error? There are lots of ways to break down federal spending, but the simple breakdown I want to call your attention to is that of interest on the federal debt and "everything else." The $990 billion in actual spending for fiscal 1986 consisted of $136 billion for interest payments on the federal debt and $854 billion for everything else.

What was the administration forecast in 1981? The total was $918 billion, divided into $63 billion for net interest and $855 billion for everything else. In other words, the $855 billion forecast for everything else was off by only $1 billion; virtually all of the error in the projection for federal spending was in net interest. The Reagan administration should be commended for its success in achieving its goal for noninterest spending. It took some luck, but represents uncanny accuracy for a five-year forecast.

But why was the forecast of net interest so far off the mark? Well, for one thing, the administration underestimated interest rates. Given the turmoil that prevailed in financial markets in 1980 and 1981, I don't think that's too surprising. More importantly, failure to foresee the 1981-82 recession, which plunged the budget further into deficit and added to the national debt, carried over into future years, pushing up spending for interest. The recession, as a result, had a double-barreled effect: pushing down revenues, thus pushing up the deficit; and then pushing up spending via increased interest payments on the federal debt.

The lesson here is that failure to forecast a recession can haunt an administration for many years because interest payments on the national debt linger long after the recession is over.

Let's shift our focus to right now. George Bush took office on January 20 and on February 9 he presented his budget plan to the nation. He started out with a forecast deficit of $163 billion for fiscal 1989. This was projected to drop almost miraculously to $91 billion in 1990 and then keep dropping until a balance is achieved in 1993. The assumptions underlying this budget are very optimistic: a strong expansion for the next 5 years at an average growth rate of 3.2 percent and no recession in sight. Most private forecasters are projecting a growth rate of 2.5 percent, which is more in line with our economy's long-run potential. This difference might sound small, but in a $5 trillion economy, it amounts to almost $40 billion a year. Translating this into revenue shortfall for the federal government, it amounts to $8 to $10 billion a year.

In like fashion, the budget optimistically assumed short-term Treasury bill rates would average 7 1/2 percent for 1989, while at the time of release they were actually 8 1/2 percent and had been rising steadily for almost a year. More incredibly, the bill rate was projected to decline steadily after 1989, reaching 3 percent by 1994. Most private forecasters think that the bill rate will still be above 6 percent by 1994.

There are those who might argue that the administration really has no choice. Gramm-Rudman requires the administration to develop a budget scenario that goes to balance. But I don't think the intent of Gramm-Rudman was to achieve budget balance by developing rosy scenarios, although that seems to be what's happening. Gramm-Rudman has not been around that long, but each year the budget planners seem to take the easy way out--"pump up" the assumptions until the budget is balanced.

Wouldn't it make more sense to impart some realism to the budget planning process? I'm not saying that they should automatically forecast a recession, nor am I forecasting one. But why not lay out some budget alternatives? For a number of years, the budget documents have stressed the sensitivity of the budget figures to economic assumptions, so I know it can be done. If some alternative outcomes were presented as a part of the budget, strategies could be developed in light of these possible outcomes.

Would the actions of Congress have been different in the 1981-86 period if an alternative recession scenario had been presented by the 1981 Reagan administration? I think so. I'm not sure what those actions would have been, but I don't think we would be looking at deficits of $163 billion right now if they had faced up to the possibility of a recession.

Sixty-eight percent of the forecasters who participate in the Blue Chip survey say that a recession will occur late this year or sometime in 1990. If this happens, the deficit is going to be ratcheted upward another notch. Rising above $200 billion is not beyond the realm of possibility. This in itself need not be cause for concern, but the experience of the last 15 years indicates a "stair-step" effect. Whenever a recession occurs, it pushes the budget further into deficit, and we never seem to get back even to where we started.

I think some progress could be made in breaking that pattern if we put some truth in forecasting. This would put teeth into Gramm-Rudman, and hopefully help us to achieve George Bush's goal of "building a better America."