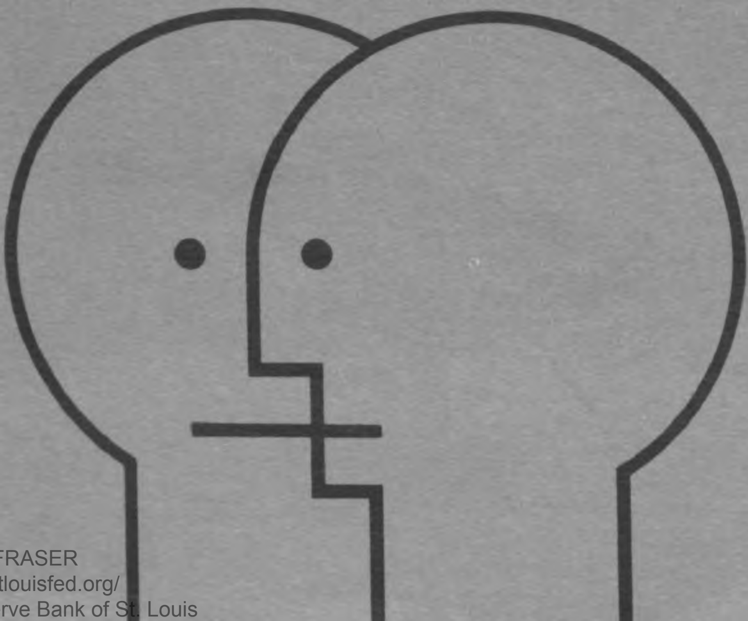
THE FEDERAL BUDGET: WHAT ARE THE NATION'S PRIORITIES?

JAMES T. LYNN
CHARLES L. SCHULTZE

RATIONAL DEBATE SERIES



THE FEDERAL BUDGET: WHAT ARE THE NATION'S PRIORITIES?

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EILEEN SHANAHAN
Moderator

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FOREWORD

The budget that the President submits each year to Congress is a statement of the administration's fiscal policy, a reflection of the administration's priorities, and an indication of the extent of federal involvement in the economy. All three of these aspects of President Ford's budget for fiscal year 1977 are discussed in this debate.

James T. Lynn and Charles L. Schultze are eloquent spokesmen for differing points of view on these matters. The arguments they present will assist readers in forming their own opinions on the complex issues involved in the 1977 budget. And the methods they use to analyze the budget will be useful in judging future budgets.

The American Enterprise Institute is pleased to present, as the twenty-seventh in its continuing series of Rational Debates, this contribution to intelligent discussion of the most important economic policy document presented each year, the federal budget.

June 1976

William J. Baroody
President
American Enterprise Institute
for Public Policy Research

CONTENTS

FIRST LECTURE

JAMES T. LYNN

In 1962, the United States reached its first $100 billion budget. Now, less than fifteen years later, the decision about the budget for the coming fiscal year—1977—turns on whether total outlays should be a little lower than or substantially above $400 billion.

This three-fold increase in outlays has been accompanied by an equally dramatic change in the makeup of the budget. Contrary to what appears to be the general public understanding, the defense budget, which was about half of the budget twenty years ago, now accounts only for roughly 26 percent. Spending on payments for individuals and grants to state and local governments, on the other hand, is up 500 percent in the last ten years. Whereas these programs accounted for about 19 percent of the budget some twenty years ago, they now claim more than 55 percent.

Now, this development has its good side: it reveals a nation that cares. As the nation has accumulated resources, it has chosen to spend them on those with unmet needs, whether people—the elderly, the poor, the sick—or communities, particularly older communities.

Unfortunately, the growth in these payments for individuals and grants to state and local governments cannot continue at the pace of the last decade or two. To give an example: If we were to continue for the next ten years the rate of growth in these human resource programs experienced in the past ten years—growth spurred not only by expanding population, but also by changes and additions to existing programs and by new programs—and if we were to accommodate that growth at the expense of the defense budget, the United States would be down to its last soldier and its last gun roughly ten years from now.

Would I like that? Would I like to have a zero defense budget? The answer is clearly yes. One cannot have worked in the Department of Housing and Urban Development for two years, or in other places in the federal government, as I have, without confronting the unmet needs in this country of people and of communities for research, for health, for education, and for so many other programs. If we lived in a perfect world, a world in which we could throw down our weapons and turn them into plowshares and be sure that others would do the same, no one—surely not I—would question a zero defense budget. But we do not live in that kind of world. The President knows that, and the American people know that. Therefore, as I put it fairly often, I believe our Number One domestic program is defense.

This year, for the first time in some years, a small expansion is being proposed for real expenditures for defense. Even at that, in dollars of equal purchasing power, the figure for defense expenditures is no higher than it was before the Korean War.

Nevertheless, we do want to cut the waste out of defense spending. The President has made proposals to the Congress that will result in $2.5 billion to $3 billion of savings—if Congress takes the necessary action. Although we must be second to no country and must have rough equivalency, the

President has given us very strict instructions that we should get rid of waste any place we can find it.

For another perspective on the budget, in 1947, total expenditures by all levels of governments—federal, state, and local—were about 18 percent of total expenditures in the United States. In 1955, they were around 25 percent. For this year, while the data are still incomplete, I would guess that total expenditures will range somewhere between 35 and 38 percent. In other words, 35 to 38 cents out of every dollar spent in the economy will be spent by one government or another.

Let us bring these numbers a little closer to home. They mean that an average family of four, earning $14,000 a year, works from New Year's Day until approximately April 15th (in an ironic coincidence, tax day) to pay all of its taxes—federal, state, and local. Putting it still another way, in a tighter time frame, this average American family works all day Monday and the better part of Tuesday before it starts working for itself—before it begins to make the money to spend on its own decisions, its own choices.

The President believes that we are reaching a point, first, where too many of the choices are being made by government rather than by the people who earn the money and the people who want to invest the money, and, second, where we must reduce the massive deficits that we have been running.

What does he propose to do about it? It is generally agreed that the federal budget for the fiscal year that begins October 1 would run somewhere around $419 billion to $425 billion if it were to be a business-as-usual kind of budget—what I call a "salami-like budget," one that retains existing programs and adds a billion here and a billion there, until, as one wag once said, it adds up to real money. This administration does not believe that the country can long stand annual increases in the budget of roughly $50 billion, around 10 or 11 percent, which has been the experience of the last two years. The President seeks to cut back that rate of growth to somewhere around 5.5 percent. And that means holding expenditures for fiscal year 1977 in the range of $394 billion to $395 billion. He also says that, as a matter of economic policy, we should start on our way toward a balanced budget in fiscal year 1979.

As most people know, this country has had very high deficits this last year—brought about, in the main, by the recession and by efforts to cope with it through increased unemployment benefits and other help to people who have been hurt by the recession. We believe that we can safely get the deficit down this year to $43 billion, by holding expenses to $395 billion.

It should be noted, however, that the $43 billion deficit—which represents a step on the way to a balanced budget two years out—would allow a further tax cut beyond that enacted last year. This further cut would give the average family of four, making $14,000, something like $227 more in take-home pay than the current tax law would allow.

At the same time, the President points to the need for some action to maintain the integrity of the social security system in the years ahead. To that end, he is asking that Congress pass a law increasing somewhat the contributions made by the employer and by the employee—by three-tenths of 1 percentage point each—to help make the social security fund whole, to prevent the depletion of its assets. Such action would offset the benefit from the proposed further tax cut, reducing it from $227 to around $180, but that is still a healthy net gain in the take-home pay of the average American taxpayer.

The President is also trying to reform a number of the programs of the federal government, and some of these reforms are necessary if expenditures are to be held at around $395 billion. In fact, some $10 billion to $11 billion of the savings implicit in that number is dependent upon congressional passage of revisions to existing laws. The rest of it, of course, depends on congressional willingness to go along with the President on appropriations for both new and existing programs.

The President has often said, "Let's get rid of programs that don't work very well to make room for programs that do." A good example of this effort is his proposal for consolidated block grants—that is, pooling the money that now goes into many individual categorical programs and spreading it around the country to states and communities on the basis of relative need. Under this approach, the precise ways in which funds are used to achieve an objective set out in the law would be determined locally.

Take the health services area, for instance. I am talking here about the current activity under the health service programs of the Department of Health, Education, and Welfare (HEW) and am not including the health service programs of the Veterans Administration, the Defense Department, and the Bureau of Indian Affairs, or the tangential programs of HUD and other agencies. The President proposes that sixteen of these HEW programs, including Medicaid, be combined in a block-grant program, with no reduction of funds, but also with virtually no growth except for Medicaid, which would rise $800 million in the forthcoming year. These funds would be sent out to the states, which would decide how the needs of lower-income families, as well as the institutional and environmental health needs of the communities, are going to be met.

What are the chances for bringing these proposals to fruition? I have to say that I do not know. We have lived in a political world in which the motto seems to have been: Spend, spend, spend; tax, tax, tax; reelect, reelect, reelect. In fact, I have wondered at times whether the motto was not simply: Spend, spend, spend; reelect, reelect, reelect.

One cannot blame Congress totally for this situation. The American people themselves, including some of the people that have run HUD, have split personalities in this regard. All of us are for restraint. We all want to hold down the deficit. We all want to get rid of inflation. We all want to get governments off our backs. But, at the same time, in this catalog of domestic assistance programs*—which included 1,006 at the beginning of the year and includes 1,030 now—there is something for every business, every person, and almost every institution in America.

What most people have said over the years is: "We're right with you, Mr. President, we're right with you, Jim Lynn, let's hold down spending—in everybody's program except mine." But today I detect that the American people are wak-

* Editor's note: *Catalog of Federal Domestic Assistance* (Washington, D. C.: U.S. Government Printing Office, 1976).

ing up to the fact that there is no "free lunch"—there is no way that this country can go on year after year with massive deficits. We must get back to balanced budgets. Doing so is inextricably linked to combatting inflation; and if the country continues to sustain inflation of the kind experienced recently, it will be a country in which the system of competition, of risk and reward of investment, cannot survive, let alone flourish.

Therefore, the Ford administration thinks this is an important year, a crossroads year. The outcome is largely up to the Congress and, in turn, to the people of the United States.

If Congress does not get a message from the people—that they want restraint, that they want programmatic reform—the nation will not get those reforms; there will be no movement toward a balanced budget, no good riddance to bad programs that do not work and no development of better programs. But if Congress does get that message from the people—the demand for restraint and reform—then restraint and reform will be enacted.

SECOND LECTURE

CHARLES L. SCHULTZE

James Lynn and I each have twenty minutes to talk about a $400 billion budget; that is $20 billion a minute. To put it in terms of the difference between us, it turns out that we are about $20 billion apart in our idea of what the federal budget should be this coming fiscal year. And that works out to a nice neat $1 billion a minute.

I want to talk about two things: The first is federal budget policy as it relates to overall economic performance—to unemployment and inflation—and, specifically, the President's budget and some alternatives to it. Second, I want to look at the particular aspects of budgetary priorities, as reflected in the President's budget, and, again, to consider some alternatives.

Let me start with the budget and the economy. At the present time, the economy is recovering at a moderately good clip from the worst recession in forty years. Moreover, the likelihood is that recovery will continue at a good clip for the next six to nine months, perhaps even a year—whatever the fiscal 1977 budget may be, because that budget will not begin to have its effects until next October. Output is now rising at 6 to 7 percent a year. The underlying rate of price inflation, while still far too high, is running at about 5.5 to 6.5 percent a year, well below the double-digit figures of 1974.

So, even if the economy is not looking great, it is recovering well. But look back to a year ago. At that time, the President proposed a budget for fiscal 1976 with a $52 billion deficit—resulting from $350 billion of expenditures and about $298 billion of revenues. That deficit was less than the drop in revenues caused by the recession; on a high-employment or full-employment basis, that budget would have been in surplus by $12 billion. When the President proposed that budget, we were warned that going significantly beyond that deficit would be dangerous, would raise interest rates, crowd out private investment, retard recovery, and possibly re-ignite inflation. Indeed, at least one member of the President's cabinet appeared to question whether even the $52 billion deficit was not going too far.

What happened? In fact, the Congress ignored that budget. It increased expenditures over and above the President's request; it expanded the tax cut beyond the President's recommendation; under the new budget procedures that it had just adopted, the Congress for the first time in history went on record explicitly voting for a budget deficit larger than the President recommended—almost $25 billion larger.

And then what happened? A pretty good recovery got under way. Inflation did not re-ignite. Despite a poor rate of growth in the money supply, interest rates did not rise. Private investment was not crowded out. And the President's reelection prospects have been improved.

I am suggesting that this year we will very likely see a repeat performance of last year. The President has come in with a very restrictive budget, and the Congress will more or less ignore it and go its own merry way—passing a responsible budget, but one with a somewhat higher deficit. And the recovery will probably continue through 1977, without re-igniting inflation.

To be a little more specific: What Jim Lynn calls a hands-off budget—no new policy initiatives, continuation of existing laws, enough additional money to agencies to account for rising prices but no more—such a budget would require expenditures of about $415 billion, given some accounting adjustments to make them conform to the President's proposals. The President's budget calls for expenditures of $395 billion, $20 billion less.

That hands-off, no-policy-change budget would cut the budget deficit next year from this year's $75 billion to about $50–$55 billion—or by about $20 billion. Such a budget would be mildly restrictive. It would place us on the path toward a balanced budget but would do so rather cautiously, because we are just in the early stages of a recovery from a deep recession.

Compared to that hands-off budget, the President's budget would, first, reduce spending by $20 billion. Second, as Jim Lynn pointed out, it would cut taxes $5 billion. Its net effect, then, would be restrictive. It would pull about $15 billion of additional funds out of the economy, or, to put it another way, it would mark a $15 billion switch toward restriction. The real outlays of the federal government—outlays adjusted for inflation—would drop by 3 percent. Indeed, outside of defense and interest, outlays would drop by 5 to 6 percent, in terms of constant purchasing power. In other words, it would be a significantly restrictive budget, pulling back on the federal government's stimulus to the economy at a time when the economy is about one-quarter of the way out of the recession.

As I have said, this set of actions would have no impact in 1976. The economy will keep on moving along. The real question is, could economic recovery continue at reasonable rates in 1977 with that kind of a budget? The President's budget obviously implies his belief that a very strong performance in the private economy will keep recovery going, more than compensating for the fact that the federal government would be very substantially pulling in its horns.

Let me remind you that to reduce unemployment by 1 percentage point a year, a relatively modest objective over the next several years, takes 7 percent annual growth in the national economy; and unemployment currently stands a shade below 8 percent.

A little exercise in arithmetic will demonstrate what is required to meet that objective of a growth rate somewhere between 6 and 7 percent a year.

First, let's take the President's budget, adjust it for inflation, and see how much the federal government will be purchasing from the economy and how much private consumption it will be financing through its social security and other programs. Add to that the purchases of state and local governments, and the sum is the total that the governmental sector of the economy would be contributing to our national recovery over the next year, given the President's budget. Then simply calculate how much the gross national product would have to grow to reach the President's own announced target of 6 percent growth in the economy.

Subtracting the first from the second tells us how much the private economy would have to grow to keep decent recovery going with the President's budget. It turns out that to reach the President's own modest targets for growth, with his budget, the private economy would have to grow at a 9 percent rate in 1977, the second year of recovery.

Finally, let us compare that required growth with each prior postwar recovery. The average rate of growth in the private economy in the second year of postwar recoveries has been 5 percent. And, within this average, in no such year has the private economy grown by anywhere near as much as the 9 percent required to keep recovery going with the President's budget. Only one year came close—the year of the big explosion in private demand, when the Chinese marched into North Korea. And even that kind of explosion will not quite do the trick.

Put in another way: If the private economy in 1977 grows at the same rate, on the average, that has characterized other postwar recoveries (again, given the President's restrictive budget), it would be a rate of growth that would hold the unemployment rate roughly unchanged in the neighborhood of 7 percent.

Clearly, therefore, the administration is taking a gamble with this budget. It is gambling that a restrictive budget, one that puts expenditures $20 billion below what they would be in a hands-off budget and gives only $5 billion additional net tax cuts, will nevertheless be consistent with continued recovery because private demand will grow at a rate well above that of any prior postwar experience.

Now, there are two ways that could happen. The first would require very cheap money, very low interest rates—that is, a very large increase in the money supply. Yet, I see absolutely no sign, either that the Federal Reserve Board is about to provide that kind of increase, or that the administration is encouraging the Federal Reserve to do so. Thus, unless things are turned completely on their heads, this condition is not likely to prevail.

The second route to an unusual expansion of private demand originates in what I call the psychological theory of reverse causation: it postulates that because businessmen and consumers in this country are worried about big government, if the administration only shows them that it intends to be very restrictive, they will be so satisfied they will substantially increase their long-range investment and expenditure programs. Thus, paradoxically, a budget that pulls the economy back will, in the end, stimulate it. To be consistent, the same people who propose this would have to assert that, when the economy is really booming, the appropriate government policy to lick inflation is to stimulate vigorously to cause the private economy to pull back. I just do not believe this psychological theory of reverse causation.

In my judgment, prudence dictates that we pursue a budget that moves modestly towards restriction during this early part of the recovery from our recession, but much less sharply than the administration's budget does. That much more moderate move would call for what I have termed a hands-off budget: expenditures continuing to move ahead to about $415 billion—and an extension of the tax cuts that Congress enacted last year, with perhaps as much as $5 billion additional.

I think such a budget would make much more sense, be much more prudent, and—though nothing in this world is risk free—run very little risk of adding significantly to inflation during the year 1977. This is not to say that the same budget policy should still be followed in 1978, or 1979, or 1980. But it is the budget policy for this stage of recovery from the deepest recession in forty years.

Now, let me turn to priorities on the domestic budget, an area where I think there is some good news and some bad news in the administration's budget.

First, I fully agree with the administration's move to consolidate, reform, and streamline a number of categorical grant-in-aid programs to state and local governments, pulling back on excessive federal control and blocking programs together to make them more rational. At the same time, one should not confuse reduction in expenditures with reform. The administration proposes to streamline, modify, and combine separate grant programs and, at the same time, cut funding for them. Logically, these are two separate actions.

Given the condition of state and local finances, and given the current situation in the economy, it seems to me that whereas grants can be consolidated, the level of grant support need not be cut. In the case of education and health grants to state and local governments, there is, indeed, a melange of individual, chaotic, topsy-like grants that need to be pulled together—but not cut by $3 billion, as the administration proposes. I see no rationale for that.

In the case of Medicaid, which is a joint federal-state program of medical care for the poor, the administration proposes a consolidation with other grants, into one big block.

That, I think, would be a move in the wrong direction. In Medicaid, unlike categorical grants for health service delivery, the direction should be toward federalizing. To put it more generally, in the various federal income-maintenance programs, like food stamps, cash welfare, and Medicaid, we should be moving to consolidate, to integrate, and to *federalize,* so as to bring about a minimum-standard federal system. In education and health services, on the other hand, the current system of chaotic, categorical, narrow little grants to state and local governments should be consolidated, integrated, and *defederalized.*

Finally, defederalization should not be accompanied by cutting. My point is that the administration has confused several issues. In the area of income maintenance programs we want more federal control, a more rational system, and minimum national standards. But in other areas, we need to turn more control over to the state and local governments. A good direction for one program area, in other words, is not necessarily a good direction for another.

Therefore, by way of cleaning up those program charts, there is good news: the administration should be congratulated for moving vigorously to do it. But there is bad news if, at the same time, the administration pulls back the level of financial support to state and local governments, for no economic or social reason dictates doing so at this time.

REBUTTALS

JAMES T. LYNN

One of the things that interests me in debates on the proper size of the deficit for fiscal year 1977 is that the reaction usually is (a) there should be a bigger deficit, and (b) the way to get one is by accommodating bigger expenditures. It seems to me, and I know that Dr. Schultze agrees, that the two issues—the proper level of stimulus by way of the deficit for the year and the means of providing that stimulus—are quite separate.

Many of my friends on the other side of the aisle are saying these days, "We really do need a much bigger deficit." But it is funny how that position always accommodates a business-as-usual growth in those 1,030 programs: once we have decided upon a big deficit and can rationalize or justify it, we can say to all you folks, "Let me tell you, that gives us a chance to add more money to all these programs. And doesn't that make me a hero with every interest group in America?"

My point is that there is a difference between the amount of the deficit and how you arrive at it. Getting a bigger one does not necessarily mean adding to these programs. It could mean lowering taxes.

The second thing that interests me is how the administration came in with a proposed deficit of $52 billion for fiscal year 1976, and now, alas, the deficit is up to $76 billion. Let me say to Dr. Schultze that we do not want to take any credit for that $76 billion; it is all yours. In fact, as the figure goes a little higher, I hope that my friends on the other side of the aisle will take full credit for it. To this day, we still do not feel—the President does not and I most surely do not—that we needed anywhere near a $76 billion deficit.

My calculations indicate that at least $10 billion—perhaps $11 billion—of that excess over what the President wanted is due to congressional initiatives and rejections of the President's proposals for recisions, deferrals or legislative changes.

The Ford administration believes the economy would be in a good recovery right now even if the deficit had not been so high. Now, that is a tough position to argue: I cannot prove it one way and Charles Schultze cannot prove it the other. Nevertheless, I am firmly convinced of it.

One last point: We hear a lot about how the government must keep up—about how the government must spend as it did before or everything will go to the devil. "Fiscal drag" is the term for it, I think. I have said it before, and I will say it again—I think fiscal drag is like the varsity drag: each one had its day, and that day has passed.

I believe that, if we give a signal to the private sector that we do mean business about getting deficits down and that the Department of the Treasury really will not be in there competing for the money, we will see very strong growth in the private sector.

Now you said, Dr. Schultze, that you would be all for that approach if we were willing to apply it symmetrically—to expand expenditures when the economy was booming. But I do not believe that is a valid test. I think we all acknowledge that there is a band of stimulus. If we should go above that band, we could encounter the troubles that other countries have had. None of us knows where the edge is—where stimulus becomes excessive. All we know is that it is a little like walking along a cliff in the dark: you do not know where the edge of that cliff is, but if you reach it and go over it, there is no way of coming back. And so with the economy. If we have left a much wider margin between us and the edge than is needed, we can always add stimulus. But it is hard to take it away once it has been applied.

CHARLES L. SCHULTZE

I have several problems with this approach. First, there is more than one place on a cliff to fall off. You can also fall off into a resumption of a recession and an increase in unemployment. I quite agree that it is a very difficult line to walk, but a little bit more fear about falling off the cliff at one point might balance the fear of falling off at another.

Second, it is interesting that, according to the administration's argument, a higher deficit does not stimulate the economy, presumably, but somehow a deficit that is "too high" will cause inflation. I do not quite understand that. It may be a kind of threshold theory: the extra \$10 billion or \$15 billion worth of deficit that the Congress put in did not help stimulate demand, but a larger deficit would somehow overstimulate the economy. I have not been able to follow that line of reasoning.

To turn to the very legitimate point that James Lynn raises: If a given economic stimulus is desired, why does it always have to be achieved through higher expenditures? Why not use lower expenditures and a larger tax cut? That surely would not bother me. However, we have to make judgments about what we buy with a tax cut and what we buy with an expenditure reduction.

Looking at the areas for which the Ford administration is planning reductions, I find that something like \$7 billion to \$8 billion of the cuts are in grants—financial support to state and local governments. In my judgment, cutting expenditures by this amount and then reducing taxes would not save the taxpayer very much. What it would mean is larger financial requirements on the part of state and local governments and thus higher state and local taxes, most of which are much more inequitable and less economically efficient than federal taxes. So expenditure reductions and tax cuts are not really such a neat, single package.

Finally, let me say quite frankly, I am not ashamed of wanting a larger deficit. In the right period of time, under the right economic circumstances, a larger deficit can be a good thing. Too much of any good thing, including candy, can be bad for you. But nothing scares me—nor should it scare anybody—about a rational argument for an appropriately sized deficit to help this economy continue on the road to prosperity.

Rational men—and I trust we are both rational—can argue about what is the appropriate size of the deficit, but deficit is not a scare word.

DISCUSSION

EILEEN SHANAHAN, *New York Times,* and moderator of the debate: You've heard the arguments about the President's proposed budget for fiscal year 1977. James T. Lynn, the present director of the budget, has told us that the budget is one that cares about human problems, that defense expenditures are as high as they are only because an unfortunate world requires it, and that the deficit is as high as it can be without running some economic dangers. And Charles Schultze, who was budget director in the Johnson administration and is now an economist with the Brookings Institution, has said that the budget presents some grave dangers to the nation: that with the economy still coming out of a bad recession, higher spending and a larger deficit are required to ensure that unemployment will keep moving down, that the economy will rebound fast enough.

Moving to the questions, I assert the moderator's privilege of asking the first one. Charlie Schultze, you have said that you approve of the President's plan to consolidate some categorical programs but that the waters shouldn't be muddied by simultaneously cutting the available funds for such things as health and education. My question is, If this is not the right year to cut, is there a right year to cut?

DR. SCHULTZE: Once you block them together, I don't see why any year would provide a reason to cut federal outlays for state and local programs for education and health. I do not see why it is not good national policy to have some significant, not necessarily rapidly growing, fraction of financial support for education somewhat redistributed from state and local governments to the federal government.

So, my answer is, I see no reason why any year in the foreseeable future would be a good year to cut those programs.

MS. SHANAHAN: Mr. Lynn, I want to ask you to comment on Dr. Schultze's statement that the economy is doing as well as it is right now—unemployment coming down nicely, inflation easing—only because the Democratic Congress violated the President's budget for last year—cut taxes more, created some additional spending, and enlarged the deficit.

MR. LYNN: I would say that is not the reason at all; but as I have said before, this will be an endless debate, particularly in an election year. I do recall that back in February and March of last year, when things were gloomy indeed, a number of economists (not including Dr. Schultze) thought that even a stimulus of $70 billion wouldn't be enough. Some people were saying that $90 billion, $100 billion, would be a good starter. There were cries of gloom and doom that, without deficits of that size, recession would spiral into never-ending depression.

I really believe that we could have gotten along just as well in the $50 billion or $60 billion range. I think the deficit initially went higher than the $50 billion because of estimating errors. The developing severity of the recession required upward revisions in the estimated deficit. More people were unemployed than we had predicted, and receipts were less than they might have been otherwise. So our deficit increased in part because of reestimates, which we learned about after the budget had been put to bed—and that's why the President dramatically drew that line with the squeaky chalk at $60 billion.

One of the things that is very difficult for a budgeteer—and I know that Charlie will agree with this—is having people understand that budget-making in large measure is estimating, and that some of those estimates are easy to make accurately and others are very difficult. For the toughest one of all, try receipts from the outer continental shelf.

MS. SHANAHAN: You missed that by a full $4 billion last year.

MR. LYNN: That's right. And, as I said this year, here are our calculations, here is how we made them, and if somebody has a better way, please be our guest. But my point is that I believe this economy made a comeback because inventories worked their way down. There was some effort toward governmental restraint. If I recall correctly, the loyal opposition took credit for having cut some $15 billion or $20 billion out of requests that otherwise would have been made by the Congress. However, though there was less governmental spending than there might have been, I believe that we would have had essentially the same recovery with even less.

What happened is that consumer confidence came back pretty strongly. People started buying. The tax reduction helped fairly substantially, I think, though I don't believe it had to be as deep as it was.

In my view, what we saw was the bleed-off of inventories through continued buying by consumers. They saw some effort by Congress—not anywhere near what we would have preferred, but some—to show some responsibility through the new congressional budget process that you talked about, Charlie. And it gave them the feeling that maybe it won't be business as usual—maybe these people really are trying to get a handle on expenditure growth.

What worries me with respect to some of the $76 billion is what it means for "outyear" expenses—those in years after this one. I look at the kinds of proposals that the President has been holding off satisfactorily so far and I'm concerned. For example, the main effects of that so-called jobs bill, which involves spending of $6.5 billion, wouldn't be felt in fiscal year 1976; $2.5 billion would come in 1977, and roughly another $2 billion each in 1978 and 1979.

Now Congress comes along each year and starts adding budget authority in these various programs. It would be well and good if the process could be fine-tuned, so that a precise amount, say $3 billion could be added for 1977. But that isn't the way it works. Instead, when Congress adds to a highway program, it also adds a little bit for other public works or an environmental unit, and the effect is felt in 1978, 1979, when we may not need or want it anymore. How are we going to turn it off then?

MS. SHANAHAN: We are now ready for questions from the audience.

ROBERT WEINTRAUB, Department of the Treasury: As I listen to you gentlemen, I am reminded of the importance of interest rates and of the fact that about a year ago, the monetarists—and their occasional or quasi-friends, the crowding-out theorists, and people at the Federal Reserve as well—were saying that if the deficits were to go above the

\$50 billion that the President was then calling for, interest rates would surely rise. They were talking, of course, about fiscal policy. Oddly enough, the fiscalists, including members all along the Brookings-New Haven-Cambridge axis, were saying that if the money supply (meaning M_1) didn't grow at 10 to 12 percent per annum, interest rates would surely rise. Curiously, as it has turned out this past year, fiscal policy was more stimulatory and the deficit was higher than the monetarists and their friends said they should be, and M_1 growth was considerably lower than the fiscalists said it should be, and interest rates fell.

Could either of you explain why?

MR. LYNN: Charlie, go ahead. [Laughter.]

DR. SCHULTZE: As a matter of fact, most members of the staff of the Federal Reserve are running around wringing their hands trying to find out why.

You are perfectly correct: with a \$75 billion deficit and the rate of growth in the money supply that the Federal Reserve announced it would pursue—it actually pursued a somewhat lower rate—every past relationship that I know between gross national product and all the other economic variables indicated that interest rates should have been somewhat higher than they now are. I like to put it this way: there has occurred what is to me—and to most of the people I know—an inexplicable decline in the demand for money, out of the range, to my knowledge, of even the more complicated past econometric models. Whether it is temporary, or what it means, I am not sure; and I don't want to suggest that there are not industrious, bright people in the country—sitting in this room, for all I know—who can explain it. But I simply don't know why.

MS. SHANAHAN: Jim Lynn, does the administration agree that this is a mystery and, if so, how does that affect policy?

MR. LYNN: I think we share in part—at least, I do personally—Charlie's uncertainty about the causes. And I'm sure a lot of theses will be written for master's and doctor's degrees over the next three or four years trying to explain them.

But I do remember hearing Arthur Burns saying for many, many moons that there is a change going on in the velocity of money and in management of money, and urging us not to keep our eye on M_1 that much, to look at M_2 and M_2 prime and some other things.

MS. SHANAHAN: Wait a minute. Let's talk a little English. How does that affect budget policy?

MR. LYNN: On the budgetary side, I have to say that I do not know precisely why, either. I can say, again, that I think part of it has been that the recession proceeded in more of a V-shape than anybody expected it to and that that had something to do with it. We had a period of three to six months in which the economy was falling off sharply—a lot more quickly than any of us thought it would. And there was a falling off in the demand for business loans, which at least partially explains the drop in interest rates.

I will say, though, that it's this very kind of uncertainty—and Charlie talks about falling off the cliff at various points—that makes me worry about sitting here in this same debate a year and a half from now asking, "Well, now, how did we get back to double-digit inflation?" and having some erudite economist explain, "Well, it was a little of the satifras with imaniseital mixing with a metafrac, and that's how we got to it."

I'm scared to death of getting back to double-digit inflation. And that is why I say you must approach that cliff of too much stimulus very, very cautiously—particularly for the year ahead, the period we're talking about.

DR. SCHULTZE: If I take, not some riproaring liberal-democratic New Haven-Cambridge-Brookings-axis forecast, but the administration's forecast of 6 percent annual growth in GNP, which I presume the administration thinks is reasonable, I have trouble seeing how this budget policy will get you there.

MR. LYNN: If I might comment on that just one second, Charlie, I've read your testimony before Senator Muskie's Budget Committee, and I've also heard you tonight. You do this arithmetic—so much by state and local governments, so much by the federal government, leaving so much that the private sector has to do. I think you will concede that one great unknown is how much substitution effect there is when you do have federal, or state or local, involvement and that we really don't know how much sliding around, of overlap or gap, there is between the private and public sectors. Isn't that true?

DR. SCHULTZE: Yes, but it's irrelevant because (a) I was very generous in not assuming much change in state and local expenditures because of the cuts in grants and aids—that is, I just assumed that substitution—and (b) I haven't said that I know what is going to happen to private demand, but only that, looking at past experience, if your scenario is to work out, private demand will have to explode as it did after Korea. Maybe it will.

MR. LYNN: Well, we put in our projection the exact figures that we expect. And I hope, incidentally, that when the congressional budget committees come out with their findings and recommendations, they will at least give explicit forecasts of their assumptions the way we did.

MEL BARNEY, Texas Instruments, Inc.: Dr. Schultze, what specifically would you spend the extra $20 billion on?

DR. SCHULTZE: Well, one way of answering that is to look at what the administration is cutting out in its $20 billion, because I think parts of those cuts—not all of them—ought to be restored, at least during the next year. In the first place, I would not reduce public-service employment as rapidly as the administration proposes—by $1.8 billion. Now, don't get me wrong: I do not happen to think that public-service employment is the world's great answer to our problems. And I don't think that is the way to get back to full employment without inflation, as apparently the sponsors of some bills on the Hill now seem to think.

I have also indicated that I do not think this is the year to pull out about $7 billion of grants-in-aid in real terms, excluding public-service employment, even though I would consolidate them.

I would handle the Medicare problem differently. The administration has, I think, a basically sound approach to Medicare: give the old people larger coverage for catastrophic expenditures, make them pay more for low, small, medical expenditures. That's a good idea; it helps control cost. But the proposal would do it in a way which would require the elderly to pay out $2 billion more than they do now. I would have the same program, but increase cash benefits by $2 billion to make up for that.

Adding up all of these things, you begin to get to my spending target for fiscal year 1977 of $415 billion. In other words, in many areas, I would tend to restructure the budget the way the administration wants to, but I would maintain the level of funding, particularly for state and local governments. In effect, that would add not all, but most of that money I'm talking about.

A. B. VAN DER VOORT, Machinery and Allied Products Institute: I would like to raise a question about the unemployment rate, which, of course, is a central concern. Isn't a lot of our unemployment structural in nature, a good deal more of it than was the case ten or fifteen years ago, and doesn't this mean that we will have to settle for a somewhat higher unemployment rate, given the same level of general economic activity, than we had ten or fifteen years ago? What unemployment rate is feasible under today's circumstances, and how can we avoid returning to double-digit inflation in the attempt to reduce it below that level?

MR. LYNN: Well, it is true that you cannot look at unemployment as a monolithic problem and assume that every person's problem is the same. First, there is a chronically unemployed group, the minorities in the inner city. They represent a classic case of a real problem that we have yet to get a handle on. Perhaps, here and there, we have made some encouraging progress, but we still haven't really come to grips with the problem. Then there are the new entrants into the labor force—not just those from high school, but also the older, married second wage earner in the family. You are right: we have to take a look at each one of those problems and address them separately. But even taking account of these special groups, our unemployment rate today still reflects the vestiges of the recession.

I think we sometimes get carried away with a precise number. I'm encouraged—I've heard it twice tonight and hear others acknowledge it—that we have made some real progress in getting the unemployment rate down in the last four to five months. When you go from a rate of 8-9 percent to 6-7 percent, as we have over the last year, that's not bad. But we still have a long way to go.

I would prefer to put it this way: our goal is a situation in which everybody who wants a job can find one. Now, whether that comes about with an unemployment rate of *X* or *Y* isn't nearly as important as achieving that overall objective.

DR. SCHULTZE: The central problem in pushing the unemployment rate down is that, as it goes lower and lower and lower and the labor market gets tighter and tighter and tighter, the threat of re-igniting inflation becomes greater. I happen to be very pessimistic about that, as a matter of fact. I think that the level of unemployment at which inflation would get ticked off again is higher than it used to be. Maybe, for a lot of structural reasons, we have to worry about renewed inflation when we get the unemployment rate down to between 5 and 5.5 percent instead of to 4 percent.

Having said that, I think that the central problem of the Western industrial world is how to get the unemployment rate significantly lower without re-igniting inflation. That may be an overstatement, but that's all right. In my view, no single thing will be more effective against the major social problems in this country than a tight labor market. We can have government programs coming out of our ears, but unless employers are really demanding labor, we're not going to get good manpower training, and we are not going to integrate the lowest 15 percent of the population into the productive system.

Therefore, because I am very pessimistic about getting the unemployment rate much below 5.5 or 5 percent without re-igniting inflation and because I think doing so is crucial for the minorities, for social problems, for people in general, I am reluctantly forced to the conclusion that we have got to find a socially acceptable way to impose wage controls. Otherwise, in the long run, we're in trouble.

So I agree fully with the import of the question, but I just think you can't give up on pushing the unemployment rate down.

JAMES CARY, Copley New Service, Washington: Given the present prospects for an improving economy, what do each of the gentlemen expect the unemployment rate and the inflation rate to be by the time the election is held in November?

MR. LYNN: Alan Greenspan, chairman of the Council of Economic Advisers, has said that he looks for an unemployment rate of somewhere between 7 and 7.5 percent in the last quarter of this year. He has also said that we will have to look carefully at the figures—

MS. SHANAHAN: Excuse me, Jim. I know you've been on vacation for five days. He has indicated just recently that, based on the other good February numbers, he thinks the rate could go below 7 before the end of the year.

MR. LYNN: Well, I was about to say—I hadn't read his latest clips in the last five days—that in talks I have had with him, he has said that if these very good figures we've had in the first two months of the year continue we would have to revise our forecast. But he wanted to see another month of the figures before he did that. I think being cautious in this area is wise. I'd rather have erred on the up side and say we've got better news than we had before.

On the inflation rate, if I recall correctly, we're saying somewhere around 5.9 for the consumer price index at the end of the year. I don't believe that Alan Greenspan has said much about changing that one.

So many things can influence a number of that kind. I hope for the best, but you can't ever tell. Our undue dependence on Middle Eastern oil is one factor: who knows what will happen there? Rainfall out in the Midwest is another factor. I must admit that ten years ago, when I practiced law, I didn't give much attention to that, but today, I give it a lot of attention. I also pay a lot of attention to the deficit and, notwithstanding conflicting views on issues where reasonable minds may differ, I'd like to see what kind of signals the Congress of the United States gives the American people and businesses by way of how big that deficit is.

MS. SHANAHAN: Charlie, do you want to comment on those forecasts?

DR. SCHULTZE: I wouldn't disagree with those conclusions. Without giving point estimates, I would say that unemployment is going to continue going down this year.

As a matter of fact, I think we had better be careful because in the next three months we may get some false signals, and, even though the situation is continuing to improve, it's just possible that unemployment will stop its decline or even tick up a little bit for technical reasons. Nevertheless, I think the chances are very high that during this year the rate of unemployment will continue down and the rate of inflation, barring bad luck on food or oil, will not reaccelerate and will stay in the range that I consider the underlying rate we're now stuck at—something between 5.5 and 6.5 percent.

So I don't disagree with you.

MS. SHANAHAN: Let me interject here. I keep seeing more and more caveats in the economic forecasts about "barring crop failures at home and abroad." Do we already know something that has brought about such an intensification of worry about this possibility?

MR. LYNN: I hadn't deliberately intensified it, Eileen, because, reading what the people in the Agriculture Department have to say, the die is by no means cast in this regard. So, this isn't a further caution, at least on my part. It is just the normal caution in that area.

MS. SHANAHAN: It seems to me it has cropped up a lot lately.

MR. LYNN: You didn't mean a pun with the "cropped up," did you?

MS. SHANAHAN: No, I didn't.

CLINTON H. WHITEHURST, Clemson University: I note that Mr. Carter, Mr. Jackson, and Mr. Wallace, on the Democratic side, have all opted for a strong national defense, and Mr. Ford and Mr. Reagan have opted the same way. The present defense budget is $100 billion plus a fraction in the fiscal year, and $112 billion for total obligational authority. Now, is this large enough, is it small enough, and what impact do the panelists see this having on the whole budget picture?

MS. SHANAHAN: Are you talking about the longer-term future, as well as the immediate year?

PROFESSOR WHITEHURST: Yes. All of the presidential candidates are arguing for greater expenditures, and I would like the panelists to give us their views on this.

MS. SHANAHAN: All right. Where will the defense budget go, where should it go, and what is the economic and budgetary impact through the next presidential term, whoever occupies the White House?

MR. LYNN: There are lots of unknowns when you take a term of four years—and we're speaking about a date four years and nine months from now. Things can happen in the world that change your estimates of the budget over that period. They could be for the good, or they could be for the bad. As both the President and Secretary of Defense Donald Rumsfeld have said, there are unknowns even now. We have a study underway on whether the Navy needs more forces, and that could result in an additional budget request. Second, if the current SALT negotiations do not come to a satisfactory conclusion, more funds may be required.

The only thing I think we can say at this point is that we believe that, subject to this kind of contingency, the budget as submitted for the next year, along with the general pattern of increases for the future, is adequate and will maintain rough equivalency. It is certainly not a rich budget for defense. If Congress rejects the expenditure savings that the President has proposed, he'll have to ask for another $2 billion to get his requested level of purchases, because he has assumed that $2 billion of savings.

MS. SHANAHAN: You're talking about the proposed pay adjustments?

MR. LYNN: Yes, adjustments in pay increases, housing allowances, commissaries—a list of efficiencies as long as your arm, some of which will require legislative change to accomplish. If we do not get those changes, we might have to increase the budget. It's adequate, but it's certainly not a rich budget.

DR. SCHULTZE: For the first time, after having declined for many years, the defense budget in real terms is turning up; that is, adjusted for inflation, or in dollars of constant purchasing power, the defense budget has now begun to turn around slightly. It will turn around a lot more with the very large increases proposed in the President's budget—for example, the 40 percent increase in the funds requested for procurement, which won't show up in expenditures for some time.

I, myself, am puzzled and a bit disturbed by the recent newspaper reports—hopefully, the CIA found out a long time ago—of a large Soviet build-up.

I think the central question probably is not so much whether the defense budget, in real terms, ought to increase. The magnitudes, given the size of our overall economy, aren't all that big. We are talking, in terms of real increase, about maybe $10 billion in procurement over several years. Looking down the road to 1980 in a $1.9 trillion economy, $10 billion isn't huge.

What really disturbs me is whether we're going to be pouring tremendous sums into sustaining a dinosaur complex. We have not yet, I think, bitten the bullet on the Navy. The issue is not one of increasing the number of Navy ships; we probably need to do so. The issue is the kind of ships. We are still going ahead to build those $2 billion floating targets that we call aircraft carriers, and we are making them all nuclear. By the way, this is not just the administration's doing. The Congress, in its infinite defense-cutting wisdom, put an item in the defense authorization bill that all ships must be nuclear unless the President explicitly said otherwise. The President didn't explicitly say otherwise, so we're building a nuclear strike cruiser.

The new Navy and Air Force planes, the F-15 and the F-16, are going to cost something like three to five times in real, constant-purchasing-power terms what their immediate predecessor, the F-4, cost.

I don't so much begrudge the increase in the defense budget. It might be necessary, finally, to turn this downward trend around and put in some more real money. But I'm beginning to worry that we're building ourselves an incredibly costly, unmanageable and, in the long run, self-defeating, gold-plated, big-target, high-expense Navy—and Air Force. It's the use of the money, not the amount, that puzzles and bothers me.

MS. SHANAHAN: I want to follow up on that because I think there is tremendous interest in the defense budget. Congressman Adams of Washington, the very thoughtful chairman of the House Budget Committee, said the other day that he felt a lot of major decisions ought to be postponed this year: the B-1 bomber, Navy modernization, the cruise missile, and the expansion in the Trident program—along with some domestic programs such as health insurance and welfare reform. His reason for believing that Congress shouldn't lock us into anything this year, shouldn't make the commitments the administration is asking for, is that this is an election year and we should wait until the people have spoken and given the next Congress and the next, or the same, President a mandate.

I wonder what both of you, as experienced administrators and budget directors who have lived in the administrative world and the political world, think about that concept.

MR. LYNN: I would say, first, that it is an interesting concept. Next year we could say that, after all, we have a brand-new President, or we have a continuing President but a new Congress for him to work with—which I hope and expect to be the case—and we ought at least to let them have a year to work together before doing anything crucial. There will always be an excuse to put things off another year.

Second, we've been putting off decisions in a number of these areas for years now.

Third, I couldn't agree with Charlie more about looking hard at each one of those programs. And both the President and Secretary of Defense Rumsfeld have asked Congress to do that, because we believe the time has come when we have to order the long-lead-time items for the B-1 bomber, when we have to move on the Trident missile, when we need the extra divisions, the extra tactical forces in the Air Force, and so on. It is true, Charlie, that the cost of those weapons keeps going up every year. The weapons get more and more sophisticated, and we live in a day when we pay in current dollars, not constant dollars.

But I do think it's good for the members of Congress to look at every one of those items. We're convinced that if they look at them carefully, they will agree that we were right in asking for them. But that, of course, is Congress's prerogative.

DR. SCHULTZE: One of the problems is, I think, that you can't make a general statement on that. You have to look at each program, by itself, to determine where you have a genuine watershed decision. For example, it may turn out —taking an example from thin air—that you can't follow this procedure with the B-1 bomber. You've got to say go or no go; you can't keep it ticking over for a year. Now, it may turn out that you can, and, if so, it might not be a bad idea. I happen to believe that that proposal is meant to keep the Air Force from being the silent silo sitters of the 1970s. [Laughter.] And it's not the way to strengthen the Air Force.

For another example, I think there is no need to make a decision this year on the long-lead-time items on a new nuclear-powered carrier—$2 billion with all the planes on its deck—that would be delivered in 1981, perhaps. And there may be some other items that could be postponed, but Jim may be right, there are a whole batch of them that you just can't wait for.

Let me add several other points. First, the manpower costs of the defense budget, for many good and sufficient reasons, have grown tremendously, eating up a large part of that budget. And I think there are economies that could be made, but, in any event, those costs are there already.

In addition, the incredibly increased cost per unit of the new equipment we're buying puts a tremendous squeeze on the quantity we can buy. So no matter whether Jim Lynn and the President put in an extra $5 billion or $10 billion, in the long run it isn't anywhere near enough to overcome this trend.

And I am beginning to believe—but am still unsure—that, unlike the last five years, the central defense debate of the next five years may not be on how big the defense budget should be and how much we can transfer from defense to social programs—which is a legitimate debate, but may be a dying one. The central debate may be, rather, on what kind of a defense establishment we want to have by way of flexibility, easy expansibility in time of war, kind of equipment, and the like.

MR. LYNN: But, Charlie, that's a very healthy defense issue. And it's the kind of thing that should be debated, quite apart from orders of priorities, because, today, I think, the American people generally don't want the U.S. to be in a second position militarily. They do, of course, value their national freedom, and a strong defense force is essential to guaranteeing this freedom. Their reluctance has arisen from the suspicion that we are building a gold-plated this, that, or the other thing which is not needed. Therefore, I think our job is to convince the American people that what we're asking for in that budget is only what we need and what makes sense. And if we can't convince them of that, we shouldn't have those things. But I think we can.

ARTHUR CAROL, economic consultant, Washington, D.C.: Mr. Lynn, for a given level of fiscal stimulus, are we to be indifferent between whether it comes from the public or the private sector?

MR. LYNN: No, I don't think we should be indifferent. I think, though, that one of the places I draw the line is using up a given amount of stimulus by adding to expenditures because it's the easy way out. Dr. Schultze talked about a $7 billion reduction in grants-in-aid. Now, reductions have been recommended in some areas. But I think Dr. Schultze's premise is that all programs should be increased by the dollar amounts necessary to adjust for inflation and should maintain the same purchasing power as a year ago. I disagree. In my judgment, a number of programs shouldn't be expanded. And yet, every year, inexorably, we give them more money. A blend of stimulus from the private and public sectors is important and I think that the President's budget offers such a blend.

I rarely hear anybody mention the increases in government outlays that our budget provides in some areas—almost a half billion dollars in budget authority for block grants for community development, for example. That outlay won't be felt for another year at least; and, as a matter of fact, outlays in this area are down slightly as the old categorical programs of model cities phase out and the new programs come in. On public works, this budget is up, if I recall correctly, some 17 percent in current dollars over last year's budget, and highways are up several $100 million. But what the President is saying is, If we want to stimulate construction, for example, let's do it through the private sector, by giving a special depreciation rate to people who build new plants or shopping centers, or the like, in areas where unemployment is highest. I'd rather do it that way than through public works on the federal side.

MS. SHANAHAN: While we're talking about that, because of my particular interest in taxes, I'm sorry that neither one of you has talked about the growth in what have come to be called tax expenditures—the taxes that are not collected because of some preferential provision in the tax laws. And, Mr. Lynn, since you are concerned about the growth in outlays, how come you never mentioned that as a problem and, in fact, just advocated a new one?

MR. LYNN: I think that issue has to be examined in much the same way as outlays. I couldn't agree with you more. And that's why, as you may have noticed this year, every time we got into a functional category in the budget we give detail—

MS. SHANAHAN: That's mandated by Congress; under the budget act you have to do that.

MR. LYNN: Well, some of the details that we included in the text of the functional statements weren't mandated by anybody. All we had to do to comply with that statute was to put in the section on tax expenditures. Showing it in juxtaposition to actual expenditures was our own doing, because we wanted to stress that not only the payment of cash by the government, but also its losses in receipts, can have a social purpose, a business-incentive purpose, whatever it may be.

I think we do have to scrutinize tax expenditures in much the same way as outlays. At the same time, we have to take a harder look at off-budget items on the outlay side: guaranteed loans, the government-sponsored agencies, and so on. Incidentally, when I hear the economists discuss the budget, they usually don't say much about the stimulus provided by some of the off-budget things in this budget.

DAVID I. MEISELMAN, Virginia Polytechnic Institute and State University: I'd like to follow up Mr. Lynn's comment on disagreement among economists about the fiscal stimulus of government expenditures.

I first started studying economics toward the end of the Second World War. At that time, the best and the brightest of the economists forecast that, because of the sharp decline in government expenditures associated within winning the war, we were likely to return to the Great Depression of the 1930s with huge unemployment. That forecast, based on a reading of the fiscal-policy numbers, was greatly in error. It turned out that when the public sector got smaller, the private sector got larger.

After that, I became an economist and I went through the usual things having to do with econometrics and what not, to win my Brownie points; and it turns out that over the long pull, when the public sector gets bigger, the private sector gets smaller, and when the public sector gets smaller, the private sector gets larger. Over the short pull, when government expenditures go up, it's very hard beyond three months—and I'm very dubious about those numbers—to know what, in fact, the so-called fiscal stimulus is.

So, Dr. Schultze, what is the basis for your arguments that somehow we need a large government budget, or that at least we ought to resist restraining the growth in the budget, to make sure that the private sector itself doesn't get smaller?

DR. SCHULTZE: The basic reason is that I don't agree with your premise. I don't think there is any warrant in postwar cycles for the conclusion that in a cyclical upturn, when the government gets larger, the private sector gets smaller. Had that been true, the recession would have continued last year and unemployment would have been about 15 percent. Strangely enough, the budget got larger and so did the private economy.

Presumably, as economists, we know that when the economy is close to full employment—that is, when the pie is a given size—if the government takes a larger slice, there is less left for the private sector. And we all know that; you're exactly correct. What I had hoped we had learned over the last thirty years was that, in periods of recession, when you increase the governmental stimulus, you can get increases both in the private and in the public sector. And there are a lot of ways to apply stimulus—not only through expenditures, but tax cuts or easier monetary policy, though here let's just talk about fiscal policy.

Now, we can argue like the devil about the magnitude of the needed stimulus and about how far we want to push it, about the inflationary risk we're running. But, I thought we had learned that it is in periods of recession that you use stimulus. Not only that, I also thought we had learned the converse: when you're in a period of inflation you can decrease the government sector and thereby also decrease the private sector and so reduce excessive demand in the economy. But maybe we haven't learned that.

CARL NOLLER, Committee to Investigate a Balanced Federal Budget, a Democratic research organization on

Capitol Hill: The National Bureau of Economic Research, I think, has said that the economy bottomed out in about April 1975. And the most optimistic estimates I've seen for anything approaching a balanced federal budget is sometime in fiscal 1979, which would be three-and-a-half years into the upturn in the business cycle.

My question to Dr. Schultze is, Can we run the massive deficits that are projected—$30 billion or more—that long into the upturn in the business cycle?

DR. SCHULTZE: Well, that's the kind of question I'm not sure I can answer without beginning to think through the specific numbers. My judgment is—but there's a lot of room for error in it—that with today's tax rates and a no-policy-change budget, we would end up with a budget approximately in balance in 1979, at a level of employment somewhere between 5 and 5.5 percent. That's roughly in the ballpark.

The deficits between then and now, as we move our way back to balance, would not, in and of themselves, disturb me. What does disturb me is that no matter what we use—budget deficits, easy money, revivalism, I don't care what—to get the economy going and to substantially lower the unemployment rate, we're in danger of ticking off inflation. And it's not so much the deficits per se that do that, as it is pushing the unemployment rate to low levels.

MS. SHANAHAN: I want to thank this lively audience and, in particular, I want to thank James T. Lynn, our present budget director, and Charles L. Schultze, a former budget director, for coming to grips with some real issues. [Applause.]

Book and cover design by Pat Taylor

THE FEDERAL BUDGET: WHAT ARE THE NATION'S PRIORITIES? pits two of the nation's most respected budget experts in a debate on the federal budget for fiscal year 1977. James T. Lynn cautions that the country cannot stand annual increases of 10 to 11 percent in spending—like those occurring in fiscal 1975 and 1976—and argues that the administration's 5.5 percent increase to $395 billion for 1977 would reduce the deficit, stimulate business and consumer confidence, and thereby promote growth in the private sector. In his view, the major programmatic initiative in the President's budget is the proposal to consolidate grants-in-aid into large block grants locally administered. Charles L. Schultze also favors consolidation of grants-in-aid but opposes the administration's recommendation that the dollar value of the grants should be reduced in the process. Schultze contends that if Congress approves the President's budget as submitted, and if the economy grows at its average pace for previous postwar recoveries, the unemployment rate will still be roughly 7 percent by the end of 1977. He recommends that federal spending be increased to about $415 billion to promote more rapid economic recovery.

James T. Lynn became director of the Office of Management and Budget in 1975, after serving for two years as secretary of housing and urban development. He moved to Washington in 1969, as general counsel for the Department of Commerce, after practicing law in Cleveland. Lynn holds degrees from Western Reserve University and Harvard Law School. Charles L. Schultze, a senior fellow with the Brookings Institution, was assistant director and then director of the Bureau of the Budget from 1962 to 1968. He also serves as chairman of the board of the Urban Institute and as professor of economics at the University of Maryland. He holds degrees from Georgetown University and the University of Maryland.

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