Research Department
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FRBSF Weekly Letter

Hit List?

As soon as the chaplain completes his reading from the Bible next Monday, the members of the 97th Congress will turn their attention to what has become a new bible on Capitol Hill—a Congressional Budget Office report on "Reducing the Federal Budget." The CBO prepared the report early last year in response to a request from eight Congressmen who wanted to find ways to stem the acceleration in Federal spending. The report undoubtedly will become "must" reading this year because of the growing belief on the Hill that promised tax reductions must be accompanied by spending cutbacks if inflation is to be held in check.

In its report, the CBO listed 56 specific areas where spending cutbacks could be made, along with 16 possible changes in "tax expenditures" (loopholes) and 3 possible improvements in administrative areas. This "hit list" could yield substantial savings from projected budget levels over the 1981-85 period—the time-span specified by the Congressional sponsors of the study. If the savings from all the individual items were totalled, they would exceed $400 billion over the five-year period. That figure is exaggerated, however, "because some of the items are alternatives to others, and because possible ripple effects in still other programs preclude a precise estimate of aggregate net savings." The savings would be substantial in any event—but so would the political costs, as can be seen from a reading of the CBO report, which scrupulously sets forth the arguments on both sides of each proposed cutback.

Surge in spending

In recent decades, Federal spending has grown substantially—in nominal terms, in real terms (after adjusting for inflation), and relative to the size of the economy. Federal receipts have also grown substantially, as many voters noted on their march to the polls in November—although the spending pace has been much faster, leading to a growing gap between the amounts collected and spent by the Federal government. Between the 1955-59 and 1975-79 periods, receipts rose from 17.2 to 19.4 percent of GNP, but spending jumped from 17.9 to 22.0 percent of GNP (see chart). The widening gap led to soaring deficits, which in the 1970's totalled $315 billion—an amount roughly matching the sum of all the deficits recorded in the nation's entire earlier history.

This situation did not develop overnight, as the CBO staff notes: "The growth and shape of the current Federal budget is largely the consequence of decisions, not of the current Congress, but of past Congresses." Budget trends were influenced by some forces which Congress itself could not affect, such as the nation's changing age composition, especially the expansion of the aged population. But Congress also responded to various interest groups pushing for a new or enlarged Federal role in caring for the old, the poor and the jobless—and in supporting those groups against the ravages of inflation. And Congress responded as well to state-and-local government pressures for Federal help in meeting the cost of highways and other public facilities.

Spending cutbacks might at first glance appear hopeless, especially if the budget is considered only in terms of broad budget categories. More than 20 percent of all Federal spending is for defense, and a bipartisan majority seems bound to increase spending in this category substantially, rather than the reverse. Another 40 percent of all Federal spending goes for social security, medicare and unemployment compensation, and most candidates last fall agreed that the bulk of these programs would not be cut. Interest on the debt accounts for another 10 percent of Federal expenditures, and those costs have been going up rather than down in line with skyrocketing interest rates. The 10 percent involved in grants to states and local governments can be cut only by shifting the burden of those programs to other governmental levels. And the programs involved in the other 20-25 percent of the budget all have their staunch partisans in agriculture, construction, health and other interest groups.

"Illustrative savings"
Faced with that problem, the CBO staff gave their Congressional sponsors a lengthy list of possible cutbacks, under five different categories. (Although termed illustrative, the projected dollar savings represented the CBO's best estimates of what could be achieved over the 1981-85 period.) Under the heading of "management efficiences," which includes ending duplication and improving program administration, the CBO staff listed a number of potential savings, such as eliminating farm deficiency payments or reforming the wage-board (blue collar) pay system. Under the heading of "better targeting" of payments and subsidies at the most needy rather than broader groups, the staff listed such possibilities as restructuring the college-student loan program or modifying child-nutrition programs.

Several other categories of savings would be accomplished simply by shifting responsibility for certain programs to the private sector or to other levels of government. For example, limiting Federal highway aid or raising user charges for airports and airways would generate large savings, although this would mean forcing other sectors to pick up the costs if they want the services continued. A fifth category of "revised judgments," which involves reversing past policy decisions which have proven too costly in the light of changing priorities, could yield savings from (for example) a hospital cost-containment program or replacement of the MX missile program by an expanded sea-based deterrent.

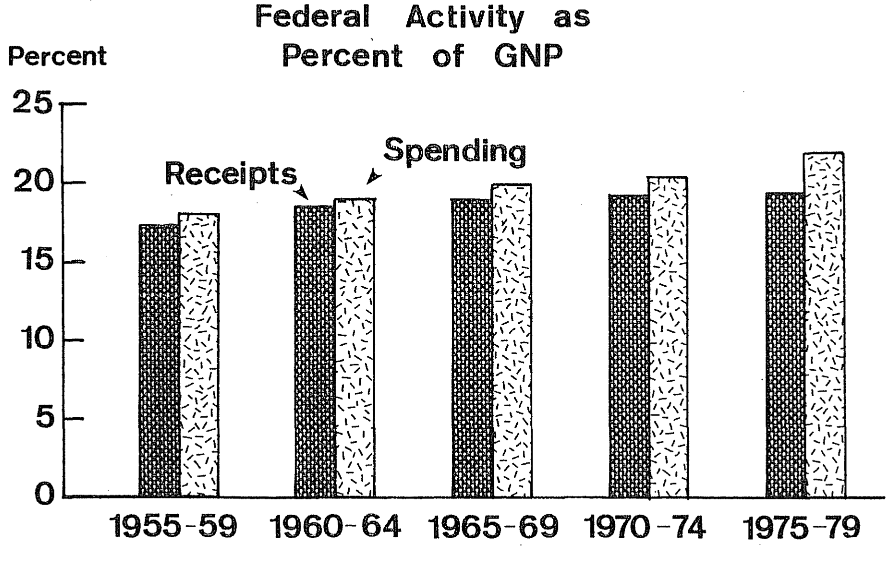
The CBO staff noted that similar reductions could be achieved on the tax side of the budget through cuts in "tax expenditures," which are special provisions in the tax code to encourage certain kinds of activity or to aid certain types of taxpayers. Examples of potential savings in this category would include limitations on home-mortgage interest deductions or termination of subsidies on (tax exempt) single-family housing bonds. Lastly, under the heading of improved administration, increases in revenues could stem from such steps as tax withholding on interest and dividend income.

Retirement programs crucial
Although savings apparently can be achieved across a wide range of Federal programs, the CBO's approach apparently would rely heavily on limitations on the growth of various retirement programs. Several proposals would involve a shift in indexing procedures. Roughly $30.0 billion could be saved over the 1981-85 period if the government used a modified consumer-price index to index benefits for about 44 million beneficiaries of major retirement plans—replacing the present CPI, which tends to overstate home-ownership costs. Again, roughly $39.6 billion could be saved if the government adjusted cost-of-living increases for social-security beneficiaries by 85 percent instead of 100 percent of the CPI increases—adjusting for the exemption of social-security benefits from income and payroll taxes. In both cases, the reason for limiting indexation would be to ensure that no group in the population obtains greater legislative protection against inflation than any other group.

Another proposal would involve the taxation of some portion of social-security benefits. If half of such benefits were taxed, the proposal would yield $36.0 billion in revenues over a five-year period. When social-security benefits were first paid 40 years ago, the Internal Revenue Service exempted them from income taxation on the theory that they represented general assistance to the elderly, who were generally poor. The tax loss was negligible in those days, but the annual loss to the Treasury could approach $20 billion in 1985, because many upper-income recipients are now subsidized by the tax-free status of such benefits. In these circumstances, taxing one-half of social-security benefits might represent the most equitable way of treating social-security and other retirement plans in the same fashion.

The CBO's list of "illustrative savings"—or hit list, as it might be called—could provide the new Congress with some very difficult decisions. There are a number of sacred cows involved, and all appear to be grazing peacefully in somebody else's garden. Strong reasons can be advanced for retaining—rather than terminating or limiting—practically every item on the list. But in this day of limited horizons, it seems imperative that Congress spend as much time examining the need for existing programs as it does analyzing the arguments for proposed new programs.

William Burke



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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 12/17/80	Change from 12/10/80	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	146,314	798	9,416	6.9
Loans (gross, adjusted) — total#	124,023	694	10,120	8.9
Commercial and industrial	37,049	705	4,435	13.6
Real estate	49,915	97	6,645	15.4
Loans to individuals	23,937	82	− 354	− 1.5
Securities loans	1,323	− 31	− 334	− 20.2
U.S. Treasury securities*	6,726	− 1	− 548	− 7.5
Other securities*	15,565	105	− 156	− 1.0
Demand deposits — total#	46,189	− 176	908	2.0
Demand deposits — adjusted	33,010	−1,068	1,118	3.5
Savings deposits — total	28,426	− 449	− 216	− 0.8
Time deposits — total#	70,979	1,040	11,958	20.3
Individuals, part. & corp.	61,633	867	11,427	22.8
(Large negotiable CD's)	28,061	339	6,034	27.4

Weekly Averages of Daily Figures	Week ended 12/17/80	Week ended 12/10/80	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (−)	n.a.	n.a.	− 30
Borrowings	64	196	208
Net free reserves (+)/Net borrowed(−)	n.a.	n.a.	− 239

* Excludes trading account securities.
# Includes items not shown separately.

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