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Clip

Senate GOP Offers Major

Slashing of Expenditures Could Threaten A Faltering Economy, Some Experts Fear

By John M. Berry
Washington Post Staff Writer

While economists generally applaud the congressional push to balance the federal budget by 2002, many caution that the budget cutting could create serious problems for the U.S. economy over the next few years.

The danger, they say, is that sharp cuts in federal spending will further slow the economy at a time when it is already beginning to weaken after three years of strong growth.

The economists explain that cutting government spending will reduce consumption—and probably also increase savings, investment and exports. Economists from both parties agree that deficit reduction will benefit the economy over the long run, but they stress that in the short term, the adjustments may be quite painful.

NEWS ANALYSIS

As the Congressional Budget Office (CBO) stressed in a recent analysis, "The major beneficiaries of a balanced budget may be future generations, who would gain from both the nation's increased productive capacity and a lower burden of debt." The current generation, however, may suffer from lower growth, lower consumption and a reduced standard of living.

Analyzing the impact of moving to a balanced budget is a highly uncertain enterprise, the economists

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Limit Approved On Jury Awards

■ The Senate yesterday approved a limit on jury awards in lawsuits over faulty products, after rejecting a broad overhaul of the nation's civil litigation system.

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Clean Water Debate

■ The House opens debate today on revisions in the Clean Water Act favored by industry groups and conservative lawmakers but opposed by the administration and environmentalists.

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stress, because it involves making what one called "heroic" assumptions about how various parts of the economy, especially financial markets, would respond.

However, there is broad agreement that cutting federal spending would tend to restrain the economy and increase the risk of a recession in coming years. The question is whether financial markets and the Federal Reserve would respond to a credible plan to eliminate the government's persistent red ink by lowering interest rates enough to stimulate investment—and thereby offset the direct impact of the spending cuts.

Officials at the Fed, including Chairman Alan Greenspan, economists in the Clinton administration and at the CBO and a number of private forecasting firms have all concluded that the budget cuts—which over the next seven years would average about 0.4 percent of the gross domestic product annually—wouldn't necessarily tip the economy into a recession. But everyone stresses the uncertainty of that conclusion.

In congressional testimony earlier this year, Greenspan, who strongly favors balancing the budget, acknowledged that "there would be some strain" on the economy before the benefits began to arrive. But at the same time, "long-term interest rates will fall significantly. . . . That will, as it did in 1993, offset" most if not all of the fiscal drag.

And if lower rates don't do the trick, the Fed chairman said, "my presumption is that there will be monetary adjustments that might be required." In other words, the Fed would act to take up the slack.

White House economist Laura D'Andrea Tyson said the administration's opposition to the Republican-backed balanced budget amendment to the Constitution, which narrowly failed in the Senate this year, was largely the result of concerns that it would lock the government into having a balanced budget regardless of the state of the economy—not opposition to moving toward balance.

Tyson cautioned, though, that the administration believes that "how one does that is as important as the goal itself. . . . To judge the economic effects, you have to know" what programs would be cut to achieve the balance. "It's all in the details," she said.

Economists say that to understand the effects of budget cutting, you need to see the economy whole—in "macro" terms. Broadly speaking, they say, cuts in the federal budget would reduce aggregate demand in the United States for goods and services. That, in turn, would mean that consumer spending would rise less rapidly than it otherwise would; but if interest rates fall, as expected, investment in new plants and equipment would go up and more of U.S. production would be exported.

"As government goes down, investment and exports go up," while consumption falls, said economist Laurence H. Meyer of Laurence H. Meyer & Associates, a forecasting firm in St. Louis. "There is an enormous degree of sacrifice implicit in deficit reduction because you cut the sum of private and public consumption. But people don't see the benefits from the investment for a long time, not really for decades."

Still, Meyer said, "that is exactly what needs to happen in the long run."

The decline in interest rates is a key part of the budget-cutting scenario. Many analysts have estimated that with a balance, inflation-adjusted interest rates would drop from 1 to 2 percentage points, which the CBO said "would leave real long-term rates at between 1 percent and 2 percent—lower than they have been since the 1950s—and real short-term rates close to zero.

"How quickly rates would fall depends on many poorly understood factors, but the drop in rates would probably anticipate any actual reduction in the deficits by a year or so," the CBO said.

Rates would fall for several reasons, including simply that the federal government would be borrowing steadily less money each year. In addition, Greenspan and other analysts say, investors would be less concerned that some day the Fed might be forced to help finance a large deficit in a highly inflationary fashion. Reducing the deficit would reduce or eliminate the "risk premium" embedded in rates because of that worry.

The lower level of rates should encourage more investment in housing and business structures and equipment, spending that would partially offset the decline in consumption caused by the government spending cuts. Of course, some of the spending cuts to be proposed this week could involve investments, such as in highways, federal buildings and research facilities, as well as in income support programs and other activities.

The payoff from moving toward a balanced budget is likely to be very slow, Meyer and other analysts said, because it takes an extended period of increased investment to have much of an impact on the nation's stock of productive capital—the stock of buildings, equipment and technology—and therefore on its productivity.

Part of the adjustment process will be a decline in the dollar, according to Meyer's view.

"If U.S. interest rates fall by 1.5 percentage points relative to the rest of world. . . . Wow! That would drive the dollar to a very low level and then it will bounce back," Meyer said.

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Spending Reductions

Domenici Plan Cuts Hundreds of Programs; Goal Is to Balance Federal Budget by 2002

By Eric Pianin
Washington Post Staff Writer

Senate Republicans yesterday offered a politically daring and far-reaching plan to balance the budget by 2002 by substantially reducing spending for Medicare and Medicaid, slashing foreign aid, accepting a further decline in defense and ordering deep, potentially painful cuts in hundreds of other popular domestic programs.

The seven-year budget plan, unveiled by Senate Budget Committee Chairman Pete V. Domenici (R-N.M.), would save nearly $1 trillion and eliminate the Commerce Department, the Interstate Commerce Commission and more than 100 other federal programs and agencies; phase out funding for Amtrak and other mass transit programs; halve the budgets of the National Endowment for the Arts and the National Endowment for the Humanities; and end President Clinton's national service program.

Domenici's plan is the first detailed attempt by either party to make the politically difficult choices necessary to achieve the first balanced budget since 1969, at the end of the Johnson administration.

"The budget that we put before you makes hard choices, and I make no apologies for that," Domenici told

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■ *Highlights of the Senate GOP plan to balance the budget.* *Page A23*

BY RAY LUSTIG—THE WASHINGTON POST

Senate Budget Committee chief Pete V. Domenici (R-N.M.), right, and Sen. Kent Conrad (D-N.D.), seated, at markup.

BUDGET, From A1

committee Democrats and Republicans. "This is a budget plan that will restore fiscal responsibility to government spending and insure a better future for our children. It responds to the unequivocal expressed American public majority that wants a balanced budget."

But Democrats denounced the plan saying it would gut social safety net programs, provide for the rich at the expense of the poor and dilute health care benefits for the elderly. "This is a retreat from what this country is about, on our values about the environment and caring for those who are poor and sick," Sen. Barbara Boxer (D-Calif.) said. "When I see it in writing, it's uglier than it sounded."

Under the plan, which will likely reach the Senate floor early next week, spending for the White House and the executive branch would be reduced by a quarter; federal judges' salaries would be frozen; the Pennsylvania Avenue Development Corporation, the National Capitol Planning Commission and the Commission on Fine Arts would disappear; and the Office of Personnel and Management would be downgraded.

The Senate GOP plan would cut Medicare spending by $256 billion and Medicaid by $175 billion, compared with the House GOP plan, which cuts Medicare by $270 billion and Medicaid by $184 billion.

Under the Senate plan, Medicaid, the federal-state health insurance program for low-income families, would be transformed into a block grant program turned over to the states to spend as they see fit and the rate of spending increases would gradually decline from 10 percent to 5 percent a year. Meanwhile, a bipartisan commission would be established to advise Congress on how to avert the projected bankruptcy of the Medicare program for the elderly.

In some select areas, spending would actually increase. Overall spending for the FBI, the Drug Enforcement Administration, the Immigration and Naturalization Service and the Violent Crime Reduction Trust Fund would shoot up. Funding for programs like Head Start, special education, Pell grants for college education and community service block grants would be maintained at current levels.

In one of its most surprising features, Domenici's proposal would make no change in the defense figures recommended by President Clinton. Republicans had talked about the need to reverse the steady decline in military expenditures over the last 10 years. But the GOP Senate plan would allow this year's $270 billion defense budget to dip to $255 billion over the next three years and then begin to rise back to $270 billion by 2002.

Six months after Republicans swept to control of Congress, the GOP this week is finally delivering on its promise to provide a detailed plan for eliminating the deficit by early next century by slowing the rate of growth of federal spending from a projected 5 percent to 3 percent and without raising taxes.

Under Domenici's proposal, overall government spending would grow from $1.5 trillion in 1995 to $1.9 trillion in 2002, while spending and revenue will go from a projected $175 billion deficit in 1995 to a $2 billion surplus by 2002. House Budget Committee Chairman John R. Kasich (R-Ohio) is scheduled to present his plan this morning for achieving a balanced budget that is similar to the Senate GOP plan, but that also provides for a major tax cut that could drain the Treasury of more than $340 billion over seven years.

Domenici is opposed to a tax cut,

but as a concession to other tax cut proponents—including Senate Majority Leader Robert J. Dole (R-Kan.) and Sen. Phil Gramm (R-Tex.)—he has designated $170 billion of long term savings that might be used for tax cuts after Congress approves a budget that is certified to eliminate the deficit.

The Republican budget plan is based on the assumption of the Congressional Budget Office (CBO) that the economy will continue to enjoy relatively smooth sailing through the end of the century. Senate GOP committee aides acknowledge that an unexpected recession, like the one that caught the Bush administration by surprise, "would raise federal deficits significantly above CBO's and the administration's estimates."

Moreover, the Senate Budget Committee Republicans are using a new yard stick or "baseline" to measure the effect of their policy changes that critics contend woefully understates the impact of the cuts on nondefense discretionary spending, general government spending that covers everything from federal prisons, border guards and job training to scientific research, veterans hospitals and environmental programs.

The new GOP baseline assumes a freeze on spending for those programs and makes no allowances for the long-term effects of inflation and other factors on the quality of government programs. According to Domenici's budget estimates, overall projected spending for these programs would decline by nearly $190 billion, or more than 12 percent, over seven years.

Yet, if inflation and other factors were taken into account, the cuts would total $446 billion over the same period, or a 29 percent reduction, according to the estimates of the liberal Center on Budget and Policy Priorities.

Domenici insisted that he devised his plan "without blue smoke," but Democrats charged that House and Senate Republicans were engaging in budgetary chicanery and that it was unrealistic to assume that the deficit could be wiped out without raising some taxes.

"You need freezes, cuts, loophole closing and taxes," said Sen. Ernest F. Hollings (D-S.C.). "That's why we're in the soup here."

Democrats again raised the issue of Social Security, complaining that Republicans were using surpluses in the Social Security trust fund to mask the true extent of the deficit.

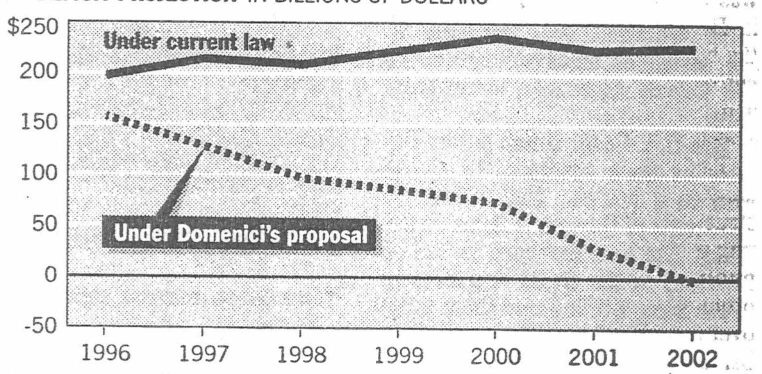
DOMENICI'S PLAN

Sen. Pete V. Domenici's budget proposal saves about $961 billion from current spending levels over seven years and creates a $2 billion surplus by 2002.

CHANGES IN CURRENT SPENDING IN BILLIONS OF DOLLARS

	1996	1997	1998	1999	2000	2001	2002	TOTAL
Defense	4	0	−2	2	6	6	8	**25**
Non-defense	−13	−27	−29	−30	−29	−31	−31	**−190**
Social Security	—	—	—	—	—	—	—	**—**
Medicare	−12	−22	−27	−36	−44	−53	−62	**−256**
Medicaid	−4	−8	−15	−23	−32	−42	−53	**−175**
Other mandatory	−14	−25	−29	−31	−34	−37	−39	**−209**
Revenues	1	1	1	−1	−1	—	—	**0**
Debt service	−1	−5	−11	−19	−28	−39	−52	**−155**
TOTAL DEFICIT REDUCTION	**−40**	**−86**	**−112**	**−137**	**−162**	**−195**	**−229**	**−$961***

DEFICIT PROJECTION IN BILLIONS OF DOLLARS



*Numbers are rounded.

NOTE: The baseline used by Senate Republicans to assess the impact of their proposed cuts assumes that non-defense discretionary spending would remain frozen at 1995 levels and makes no allowances for the effects of inflation. If inflation were factored in, the proposed cuts in non-defense spending would total $446 billion over seven years, according to the Center on Budget and Policy Priorities, far more than the $190 billion figure contained in the GOP budget documents.

SOURCE: U.S. Senate Budget Committee

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