Fiscal 1981 Budget Recommendations

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This **Economic Commentary** *summarizes the president's budget, highlighting the many uncertainties surrounding the estimates; it then places postwar budget trends in perspective.*

The president sent his budget recommendations for fiscal year (FY) 1981 to Congress on January 29, 1980. Outlays are expected to equal $615.8 billion in FY 1981, up from $563.6 billion in the current fiscal year. The budget includes some spending initiatives, most notably for defense and energy. Receipts are expected to total $523.8 in FY 1980 and $600.0 billion in FY 1981. Scheduled increases in social-security taxes and the proposed windfall-profits tax would contribute significantly to this hefty increase in receipts. The deficit is expected to narrow to $15.8 billion in FY 1981, after expanding in the current fiscal year to $39.8 billion. These figures are naturally sensitive to uncertainties in the economic and political outlooks; however, the estimates are useful in forming a base from which to analyze budget alternatives.

Budget Priorities

Administration budget recommendations contain, explicitly or implicitly, a set of priorities that presumably would guide policy over coming fiscal years. A stated primary objective of this year's budget is to reduce inflationary pressures by lowering the deficit in FY 1981 and by achieving a surplus in FY 1982. To this end, no tax cuts are recommended by the president. On the other hand, the administration suggests no major spending cuts to promote this objective and indicates that it would abandon this budget priority in favor of fiscal stimulus if economic activity slowed sufficiently. Moreover, the previously planned objective to balance the budget in FY 1981 apparently will not be achieved. These developments have raised questions about the seriousness of the administration's commitment to this budget priority.

A second objective of recent budgetary policy is to increase the nation's defense capabilities. Nevertheless, the increases proposed in military outlays for FY 1981 and future fiscal years are small relative to GNP and previous budgets. The budget message also recognizes the need to lower taxes, though not in FY 1981, if only to prevent the tax burden from rising as inflation shifts revenues to the public sector.

The difficulty of assessing priorities in FY 1981 adds to the uncertainty about the future course of budgetary policy. Moreover, as suggested below, the simultaneous attainment of a balanced budget, increased defense spending, and lower tax burdens may not be feasible in future budget years unless Congress and the current administration are willing to make substantial reductions in the growth of transfer and aid programs. Cuts in these programs historically have been difficult to achieve.

Outlays and Receipts

The budget as summarized in table 1 suggests that federal spending will increase faster on average during FY 1980 and FY 1981 (11.8%) than in the previous 10 fiscal years (10.4%). Although the increase represents, in part, the costs of maintaining existing budgetary programs, spending initiatives, notably for military defense and energy programs, are proposed. Moreover, the budget proposes some spending cuts in such areas as welfare benefits and federal employee compensation, where it has been difficult to gain congressional acceptance in the past.

Receipts will grow 13.5 percent on average during FY 1980 and FY 1981, compared with an average 9.7 percent over the past 10 fiscal years. Much of the increase represents the effects of inflation and previously enacted social-security tax increases. Various proposals, notably the windfall-profits tax, add a net $21 billion to receipts in FY 1981.

When the net spending of off-budget agencies is added to the budget deficit, the total deficit to be financed rises to $56.5 billion in FY 1980 and $33.9 billion in FY 1981. The federal government expects to raise $44.3 billion from the public in FY 1980 and $33.1 billion in FY 1981, which places upward pressure on interest rates and reduces credit-market funds available for private borrowing.

Budget Uncertainties

The administration's budget proposals are based on a number of assumptions about the economic outlook and congressional acceptance of policy proposals. If these assumptions do not hold, actual spending and taxing totals could be much different than currently forecast.

Table 1 Administration's Budget Estimates
Billions of dollars

	FY 1979 (Actual)	FY 1980	FY 1981
Outlays			
Current services[a]	--	560.6	612.0
Policy changes	--	3.0	3.8
Military	--	(0.9)	(3.7)
Energy	--	(0.5)	(2.4)
Other increases	--	(1.7)	(7.4)
Reductions	--	(-.2)	(-9.7)
Total	493.7	563.6	615.8
Receipts			
Current services[a]	--	517.4	579.0
Social-security tax[b]	--	(12.7)	(28.7)
Policy changes	--	6.4	21.0
Windfall-profits tax	--	(6.2)	(14.4)
Other	--	(0.2)	(6.6)
Total	465.9	523.8	600.0
Deficit	27.7	39.8	15.8
Deficit plus off-budget spending	40.2	56.5	33.9
Net public borrowing	33.6	44.3	33.1

a. Effect of continuing existing spending programs and taxing laws.
b. Includes the effects of all rate and base changes since January 1, 1979.

SOURCE: Office of Management and Budget, ***The Budget of the United States Government, Fiscal Year 1981*** (1980).

Projections of economic activity that span two years obviously are subject to considerable error, yet such projections are crucial in constructing the budget. Economic developments, to a large extent, automatically affect the levels of taxing and spending. Many receipts, such as income taxes, and expenditures, such as unemployment compensation, are directly influenced by the levels of production, employment, income, and inflation. At the same time, economic activity is influenced by budget decisions, which in part are designed to promote economic objectives.

The FY 1981 budget anticipates a mild recession in 1980. Real GNP is projected to fall 1.0 percent in 1980 (fourth quarter to fourth quarter) and then increase 2.8 percent in 1981. The unemployment rate is expected to rise to 7.5 percent by the final quarter of this year and 7.3 percent by year-end 1981. The GNP deflator, the broadest measure of inflation, is forecast to increase 9.0 percent in 1980 and 8.6 percent in 1981.

Many economists recently have revised upward their outlooks for real growth and inflation, partly in anticipation of hefty military expenditures. Some no longer expect a recession. Nevertheless, events lend themselves to many interpretations, and many economists continue to forecast a worse recession and higher inflation than the administration.

If, for example, real economic activity is worse than forecast in the administration's budget, federal expenditures would be larger, receipts would be smaller, and the deficit would expand. If, however, inflation is higher than the administration predicts, outlays and receipts would be higher. The net budget impact most likely would be a slight reduction in the deficit.

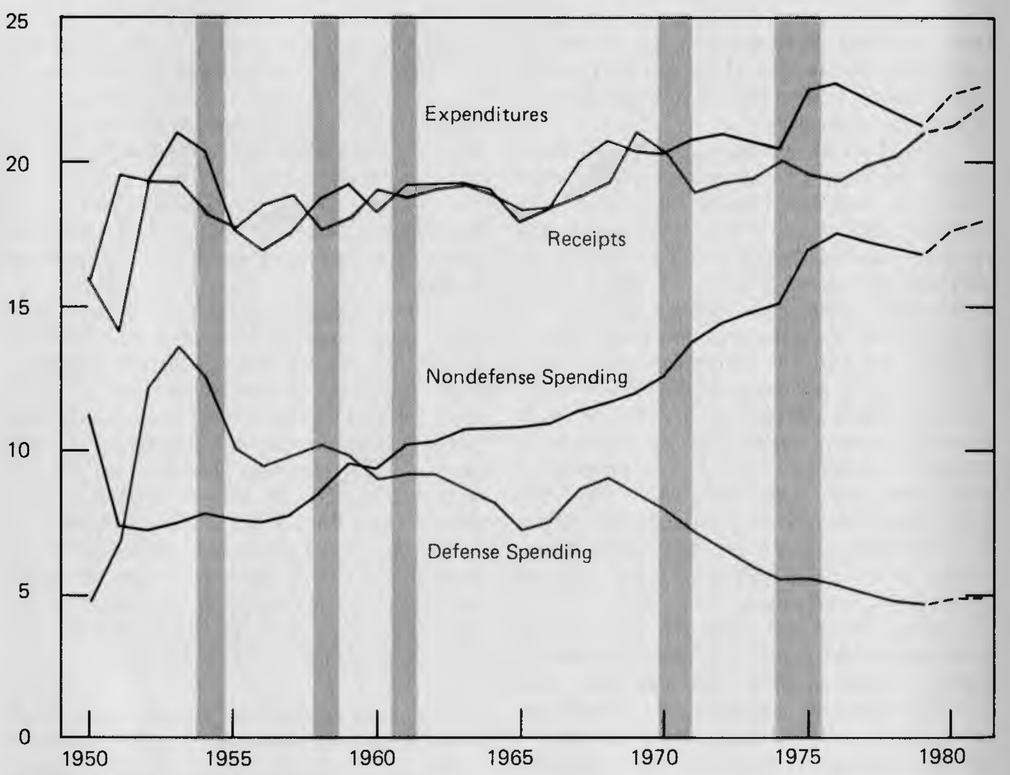
The administration's January budget, which is but one of many steps in the budgetary process, is based on numerous legislative assumptions. Various congressional committees will review the president's spending and taxing proposals, and undoubtedly they will alter some proposals, delete others, and introduce yet others. The president proposed, for example, a $15.8 billion increase in military spending during FY 1981. Although this represents a 3.3 percent real addition to the defense budget, it does not significantly increase the military's share of the total federal budget or of GNP. Many analysts expect Congress to augment greatly the president's defense budget because recent events in Iran and Afghanistan have increased public support for military spending. Similarly, in the coming election year, Congress may be more inclined than the president to raise discretionary counter-cyclical spending or to offer tax reductions in the face of weak economic performance. Moreover, some measures proposed in the FY 1981 budget, such as the recommendations for hospital-cost containment and accelerated income-tax payments, failed to pass Congress last year. Other measures designed to reduce future compensation for federal employees and lower welfare and veterans' benefits may not receive congressional support this year. The congressional budget process spans about eight months.

The uncertainties concerning the economic outlook and congressional acceptance of the administration's policy initiatives could easily cause the deficit to be much different than currently anticipated. For example, the current estimate for outlays in FY 1980 is $32 billion higher than the original estimate made in January 1979; the estimate for receipts is $21 billion above the original, and the anticipated deficit is $11 billion higher.

Perspectives

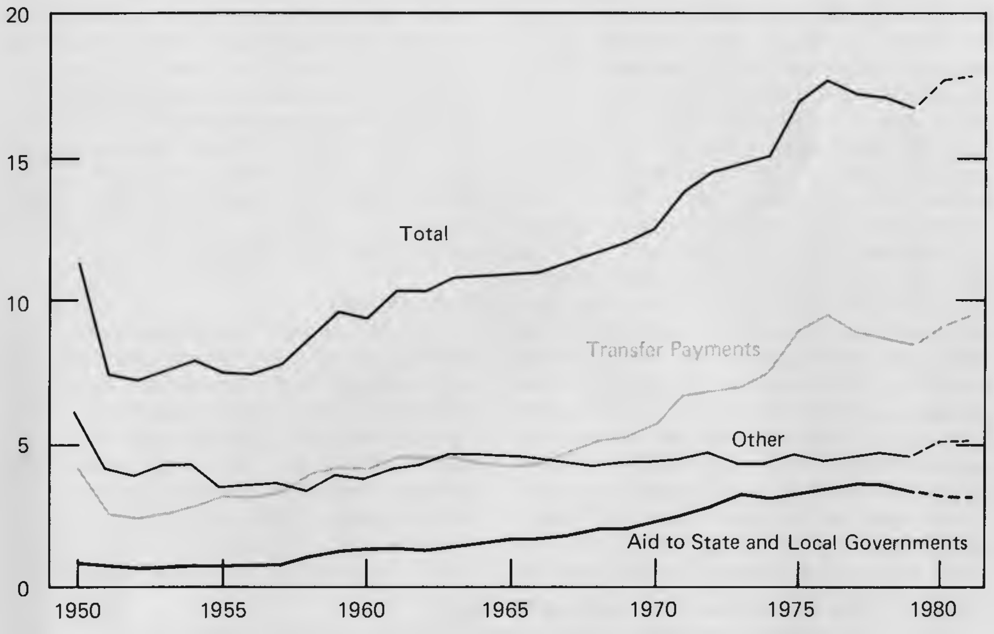
It is useful to compare President Carter's spending and taxing proposals with past budgets. Such comparisons provide an indication of the capacity to achieve various, possibly conflicting, budget goals in the near future, such as simultaneously balancing the budget, increasing defense spending, and reducing taxes. Select budgetary totals are presented as a percentage of GNP in charts 1 and 2. Expressing the budget as a share of

Chart 1 The Growth of the Federal Budget
Percentage of GNP, National Income and Products Account Basis; Fiscal Year



NOTE: Shading indicates periods of recession.

Chart 2 The Rise of Nondefense Spending
Percentage of GNP, National Income and Product Account Basis; Fiscal Year



GNP provides a framework by which to judge the relative size of government spending or taxing and to standardize the data for comparison over time.

The ratio of receipts to GNP provides a rough indicator of the overall tax burdens that the economy bears (see chart 1). Between 1950 and 1979, the ratio generally remained within the 18 to 20 percent range, although an upward trend in the ratio is discernible. Over the 29-year period, the composition of taxes also changed. Contributions for social insurance rose from approximately 2 percent of GNP in the early 1950s to about 6.5 percent of GNP by 1979. Personal income taxes also increased from about 8 percent to about 9.5 percent of GNP over this time frame. On the other hand, corporate and excise taxes fell relative to GNP from about 5 and 3 percent, respectively, in the early 1950s to about 3.5 and 1.5 percent, respectively, in 1979.

Since 1976, the ratio of total federal receipts to GNP has risen rapidly, reflecting higher social-security tax burdens and inflation-induced increases in income-tax rates. This increase has occurred despite personal and corporate income-tax reductions during intervening years. The proposed receipts would rise sharply in FY 1980 and FY 1981 to 22% of GNP, the highest level in the postwar period. Higher energy and social-security taxes scheduled to take effect since January 1980 appear to account for all of the increase in the ratio. In the absence of these policy changes, however, taxes would equal about 21 percent of GNP in both fiscal years, still a record level for a peacetime budget.[1]

Total federal outlays have grown faster than total receipts since the early 1950s. Except for the Korean War period, however, they remained below 20 percent of GNP until the late 1960s. Since then, total federal outlays have consistently exceeded 20 percent of GNP. Because spending usually has outpaced taxing, the budget has shown only six surpluses since 1950, the last occurring in 1969. As chart 1 illustrates, the deficits have grown relative to GNP and have persisted during periods of business recovery, particularly since the late 1960s. Large deficits over this period contributed to inflation.

1. The 1969 bulge in the receipts series results from the surtax imposed to reduce inflationary pressures associated with the Viet Nam military buildup.

All of the growth in total outlays relative to GNP resulted from growth in nondefense spending. The share of GNP devoted to defense has fallen sharply since the Korean War buildup and particularly since 1970, although the trend was interrupted on several occasions, most notably in the Viet Nam military buildup in the late 1960s. The $15.8 billion increase proposed in the FY 1981 defense budget represents only a small increase in military spending relative to GNP. The proposed military spending would equal 4.8 percent of GNP in FY 1980, up from a low of 4.6 percent in FY 1979, but still below the ratio in FY 1977. Moreover, the increase is as much a reflection of sluggish GNP growth as it is a change in spending patterns. If GNP grows at 11 percent, which is less than the average growth experienced over the past five fiscal years, defense spending would not rise relative to GNP in FY 1980 or FY 1981. Even if Congress greatly augments the defense budget, the ratio would remain well below that experienced in the early 1970s.

Nondefense Spending

The rapid growth of nondefense federal spending relative to GNP reflects the expansion of federal transfer payments to individuals and grants-in-aid to state and local governments. Transfer payments to individuals, which equaled less than 3 percent of GNP during the early 1950s, fluctuated around 9 percent of GNP during the late 1970s. They alone now constitute a larger share of total GNP than military defense. Similarly, grants to state and local governments increased rapidly from less than 1 percent of GNP to roughly 3.5 percent of GNP since the early 1950s. In contrast, the growth of all other nondefense spending categories has remained comparatively flat relative to GNP.

Growth in transfer payments and aid programs has been particularly strong since the mid-1960s, following the introduction of President Johnson's Great Society programs. Between FY 1969 and FY 1979, for example, social-security benefits increased fourfold, medicare and medicaid outlays rose fivefold, and food-stamp payments increased from approximately $200 million to $6.8 billion. Most transfer and grant programs are open-ended entitlement programs. Any person or government meeting the eligibility requirements established under the authorizing legislation for these programs may participate. In the absence of new congressional limitations on eligibility, spending for these programs automatically grows with increases in population and the percentage of elderly citizens, downturns in economic activity, and inflation (because often programs are indexed to keep abreast of price increases). Open-ended programs account for about 59 percent of the total budget outlays anticipated for FY 1981; in 1967, they accounted for only 36 percent of total spending.[2]

No budget program is, however, beyond the ultimate purview of Congress. The rapid expansion of transfer and grant programs has clearly had the tacit approval of Congress and the administration. These programs, however, serve a broad constituency that includes powerful interest groups. Consequently, past Congresses and administrations have been reluctant to re-examine the need for various programs or to tighten eligibility requirements. President Carter, though offering some relatively minor welfare reforms, proposes no major re-examination of these programs during FY 1981. Moreover, because these programs are indexed, inflation does not erode their relative importance in the budget.

Conclusion

The FY 1981 budget recognizes the need to move toward balancing the budget in coming fiscal years, to increase expenditures for defense, and to lower the overall tax burden. These objectives may not be simultaneously feasible, particularly when viewed in a historic perspective. The United States, particularly since the mid-1960s, has dramatically increased domestic transfer and grant-in-aid spending by incurring large deficits and reducing the real value of the defense budget.[3] If the budget is to be balanced, military spending increased, and tax burdens lowered over the coming fiscal years, the growth of nondefense spending must be sharply curtailed. The traditional reluctance to re-examine nondefense programs suggests that budget priorities as implied in the administration's FY 1981 budget may have to be re-evaluated.

2. Office of Management and Budget, *The Budget of the United States Government, Fiscal Year 1981* (1980), p. 43.

3. See also Rudolph G. Penner, "Federal Budget Dilemmas in the 1980s," *The AEI Economist* (American Enterprise Institute for Public Policy Research, Washington, D. C.), October 1979.

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