The Gramm-Rudman amendment: a wrecking ball gone out of control

by David Goldman

Gramm-Rudman—even under the fairy-tale assumptions prevailing on Capitol Hill—describes a spiral of budgetary chaos leading to economic decline, economic decline leading to *higher deficits,* higher deficits leading to tax increases, and tax increases provoking further economic decline. The reality is worse. The U.S. government is holding the bag in a general crisis of the financial system, in which every new institutional failure will demand additional billions of dollars of federal support. To adopt automatic budgetary constraints in the present financial environment is equivalent to a jeep driver reacting to a minefield by setting his vehicle on automatic speed control, donning a straitjacket, and stepping on the gas.

Under the unlikely premise contained in the Washington "consensus" forecast of slower but positive economic growth in the United States during 1986 (about 1.5% per annum), the Gramm-Rudman-Hollings legislation will dictate more than $100 billion in budget cuts, including a $50 billion defense cut, for the 1987 fiscal year beginning next September. The arithmetic, employing the usual rules-of-thumb employed by the Congressional Budget Office, is trivial:

Fiscal 1986 deficit	$230 billion
plus effect of slower growth	$10 billion
plus consolidation of off-budget accounts	$10 billion
Total	$250 billion
less Gramm Rudman ceiling for FY 1987 deficit	$144 billion
equals mandated cuts	$106 billion

Of course, the "consensus forecast" is nonsense. The world is in the midst of a deflationary breakdown crisis, in which the current free-fall of the oil price typifies the conditions which will throw large portions of the world financial system into bankruptcy over the next several months. A deficit forecast for Fiscal 1987 in the range of $300 billion, due to lost revenues and increasing entitlements claims under conditions of widespread layoffs, is more realistic.

The above exercise, conducted with the help of Congressional Budget Office staffers, corresponds roughly to what *Washington Post* columnist Hobart Rowen offered in a Jan. 23 column entitled, "Gramm-Rambo":

> Here is the devastating arithmetic, as compiled by senior staff people on Capitol Hill. From the current deficit estimate of $220 billion for fiscal 1986, subtract mandated $11.7 billion reduction. That would reduce this year's deficit to $208 billion. Thus, to reach the G-R-H target of $144 billion for fiscal 1987, there will have to be additional cuts of $64 billion—five to six times the reductions the agencies are now scrounging to meet.
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> But wait a moment, says a Joint Economic Committee economist: What happens if the economy proves to be weaker this year than the 4% economic growth rate projected by the Reagan administration. . . . "Suppose the growth rate is projected at 2.5%," says a leading Hill economist. "Since each one point of GNP is worth $18 billion in tax receipts, that would add $27 billion to the budget reductions needed to meet the Gramm-Rudman deficit target of $144 billion for fiscal 1987."
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> That would mean a budget cut not of $64 billion on Oct. 1, but $91 billion. In the real world, such a budget amputation could not take place.

Instead of instilling a sense of predictability in the financial markets, as the legislation pretends, Gramm-Rudman has set off a series of panic reactions in anticipation of much higher taxes, as former Council of Economic Advisers chairman Alan Greenspan predicted before the American Economics Association on Dec. 31. The anticipation of these tax increases will, by itself, set in motion the worst effects of Gramm-Rudman, before any actual cuts have been made.

By the time we reach the statistical stratosphere of $100 billion-plus tax cuts, the numbers become irrelevantly large. Under no circumstances can the federal government reduce expenditures by $100 billion, without general, unilateral disarmament, and without imposing conditions of hardship upon sections of the population dependent upon entitlement

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programs, sufficient to cause general social instability. In any case, if the economy goes into negative growth for four successive quarters, the Gramm-Rudman strictures are automatically suspended. Nonetheless, the operation of the legislation automatically steers the economy into a deflationary disaster, by straitjacketing the federal government's capacity to intervene into the crisis.

During the past three years of supposed economic recovery, the speculative bubble that passed for economic growth depended, in almost every case, upon direct federal support. Gramm-Rudman, especially in context of debate over tax reform, closes out the entire range of subsidies and loopholes. In an economy which consists of nothing *but* subsidies and loopholes, the drying-up of the federal teat will have repercussions that the prognosticators have not yet even attempted to imagine.

Most remarkable is that neither the Congressional Budget Office, nor the Office of Management and Budget, nor the Brookings Institution, nor the usual oracles from which economic advice is dispensed, have bothered to follow through on the implications of this arithmetic—except for the handful that predict massive tax increases in order to avoid the budget cuts.

The most devastating effect of Gramm-Rudman is that it has locked the Congress and administration into the equivalent of a debate on fuel-saving maneuvers on a ship entering an iceberg zone. By the time reality intervenes, i.e., when the hull crumples on an iceberg, it will be too late. Sometime during the summer, when the next round of deficit projections appear, or perhaps after the Treasury has had to pick up the pieces of Bank of America or other failing financial giants, a "crisis atmosphere" will develop in Washington. In anticipation of that, entire sections of the economy will begin to flake away.

Absurb assumptions

The current Congressional Budget Office growth forecast for "real" (inflation-adjusted) Gross National Product for 1986 is 3.4%, against the administration's 4% forecast. A General Accounting Office report released Jan. 21, 1986, concludes:

> . . . the OMB and CBO real growth forecasts are well within the range of current private sector forecasts. At the same time, both agencies, but especially OMB, forecast somewhat faster real growth than is expected by . . . the private sector consensus. . . . Differences with respect to unemployment are minor and are consistent with the differences in the forecasts of real growth. Finally, the OMB and CBO forecasts of interest rates seem to be consistent with current private sector thinking.

However, the GAO study adds the following remarkable statement concerning the assumptions beneath the optimistic consensus:

> Several positive factors suggest that a recession is unlikely:
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> The deterioration in the trade balance should be behind us as a result of last year's (15%) decline in the dollar;
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> Last year's rapid money growth and declining interest rates suggest higher real growth in 1986. In particular, lower interest rates should support renewed strength in housing starts;
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> Expected further declines in oil prices should moderate inflationary expectations, giving the Federal Reserve room to respond to any weaknesses that seem to be developing.

All three conditions listed imply the opposite of what the GAO (as well as the government and private forecasters) conclude from them. As *EIR* exhaustively documented in its October 1985 *Quarterly Economic Report,* the trade deficit equals about one-sixth of all physical goods consumption in the United States; since it would cost roughly 60% above the September 1985 dollar-cost of these imports to produce them at home, and since our trading partners accept our IOUs in return for them, these goods amount to a straight subsidy of U.S. economic activity.

Electronics, automobiles, primary metals, and a wide variety of other industries are dependent on cheaper imports. It is not simply a matter of higher U.S. inflation due to more expensive imports; higher import costs will raise production-costs (in terms of the price of semi-finished production inputs) to the point of unprofitability in many sectors. America's capacity to export is limited by the catastrophic debt position of its major trading partners, more than by the price of its goods.

Second, the Federal Reserve's largesse in money growth during 1985 fueled a 20% per year rate of growth of consumer debt during the first three quarters, permitting the economy to maintain the semblance of growth despite the continued deterioration of physical-production capacity. The GAO admits as much in the report's next sentence: "Consumer spending has been outstripping income growth, leading to a historically low personal savings rate." Where, then is the "higher real growth" to come from?

Finally, the free fall of oil prices—hailed by the White House as a positive factor, as spot market prices on Jan. 20 dipped below $20 per barrel for the first time in seven years—threatens to blow out not merely such debtors as Mexico, Nigeria, and Indonesia, but a large part of the U.S. energy sector as well.

On the negative side, GAO cites "the moderate rate of manufacturing capacity utilization and the high office and apartment vacancy rates, [which] should weaken the attractiveness of business investment."

The problems in the real estate sector are at the heart of the matter, as we shall discuss below.

Surprisingly, GAO does not mention:

1) the fact that 600 savings institutions are operating in the red, and half of those have a negative net worth;

2) the bankruptcy of the $80 billion Farm Credit Administration and, by extension, of almost all of the $220 billion in outstanding agricultural credit;

3) the fact that Bank of America posted a $338 million loss for 1985, facing continuing loan problems, and threatening a repeat of the Continental Illinois fiasco of 1984;

4) an uninterrupted chain of bank failures continuing, last year's postwar record of 115 commercial bank failures;

5) the implications of collapsing oil prices for Third World debtor nations, particularly Mexico and Nigeria.

Former chairmen of the Council of Economic Advisers Alan Greenspan and Paul McCracken call for tax increases to cushion the impact of the mandated budget cuts. But the effect *already registered* after the President merely proposed to substitute $25 billion in corporate taxes for a $25 billion personal income tax cut, indicates what chaos would be unleashed by this kind of "solution."

Real estate

The high office and apartment vacancy rate cited by the GAO indicates one of the mines which Gramm-Rudman will detonate. Most of the employment increase in the United States during the past five years depends upon the *credibility* of real-estate deals marketed either to institutions or individual investors, for whom tax advantages determine whether a proposal is profitable or not. The federal government has been the godfather of this bubble, and its withdrawal would collapse the bubble almost instantly.

The federal government currently has outstanding $525 billion of so-called agency issues, bonds emitted by "federally sponsored corporations" such as the Federal Housing Administration, the Government National Mortgage Association ("Ginnie Mae"), the Federal National Mortgage Association ("Fannie Mae"), and so forth. Almost all of it (including most farm-related lending) underwrites real estate development of one sort or another.

The federal mechanism for underwriting the trillion-dollar mortgage market dovetails with provisions in the tax code, now in jeopardy under "tax reform," permitting real-estate investors to write off interest as an expense, and use the benefits of low-equity leveraged investments for tax purposes. Virtually all commercial and residential construction in the United States depends upon this combination of mortgage-market underwriting and tax subsidies. Whether the current version of tax reform according to House Ways and Means Committee chairman Dan Rostenkowski (D-Ill.) is adopted, real-estate operators now operate under the assumption that the federal teat has run dry.

Until the President's budget for FY 1987 is issued at the end of January, we will not know the precise disposition of the off-budget agencies. However, assume in advance (as the real-estate market does) that off-budget borrowing authority will be reduced. Gramm-Rudman forces the goverment to report all off-budget expenditures on a consolidated basis, effectively ending off-budget status for such agencies.

For that matter, the administration is expected to propose the sale of the Federal Housing Administration to the private sector, along with other government agencies and functions.

Much more hangs on the end of this combination of market support and tax subsidy than real-estate development per se. Virtually all of the 10 million increase in employment during the past five years has occurred in sectors such as retail trade, restaurants, and so forth, which are intimately linked to real-estate values, through the development of shopping malls. Anything that disturbs the balance between the rental rate of retail and restaurant floor space, the tax benefits derived from holding such real estate, and the anticipated capital gain on the underlying real estate, will produce disastrous effects throughout the economy. It will no longer be feasible to rent retail and restaurant floor space at current rates, if the tax and capital-appreciation advantages of owning such space are wiped out. The employment associated with such real-estate development, particularly in the spreading blight of suburban shopping malls, will disappear.

That is all the more true, because the most aggressive development has occurred in those parts of the country which earlier benefited from the oil boom. The collapse of oil prices will have an additional effect, producing high bankruptcy rates and rapid disemployment throughout the Southwest, Rocky Mountain states, and other affected areas.

Insurance

Mere anticipation of the end of tax breaks for the property-casualty insurers has triggered 400-to-1,000% premium increases for a wide variety of liability coverage, and the elimination of certain types of coverage altogether. The insurers have known for a year that the old tax code, which allowed them to run operating losses as a tax shelter for investment income, would be eliminated under whatever tax changes emerged this year.

It is impossible to estimate the costs of the economic chaos ensuing from the sudden unavailability of liability coverage at less-than-impossible rates, for many sectors of manufacturing, including chemicals, pharmaceuticals, sporting goods, child products, weapons, as well as transportation and construction. Two large trucking firms have filed for bankruptcy rather than pay the higher rates. These costs will run into the high scores of billions, if not the low hundreds of billions of dollars. Robert Hunter of the National Insurance Consumer organization suggests that the total costs are two to four times the annual increase of premiums paid, of $25.6 billion last year. In other words, the insurance spinoff effect is in the same range as the FY 1987 Gramm-Rudman budget cuts. The trigger for these additional costs to the economy is less than $5 billion in additional taxes.

Defense

While attention has focused on the *size* of defense budget cuts, the *nature* of these cuts under Gramm-Rudman may be just as devastating for arms procurement, even if the size of the cuts is relatively low. The specific approach dictated by the legislation throws the defense industry into utter chaos. Since defense makes up 6% of all industry shipments, and perhaps twice that amount of investment, the impact on the economy, let alone upon national security, will be devastating.

A private research report released Dec. 19 by the New York investment bank Oppenheimer and Co. warns:

> The "across-the-board" cuts (horizontal) suggested by Gramm-Rudman are highly impractical and have a historical record of cost ineffectiveness. Given that the Pentagon has upwards of 200,000 contracts outstanding at any one time, it would be ludicrous to expect a biannual review of each program. Moreoever, lower funding for individual programs tends to inflate unit costs, resulting in fewer but more expensive systems. Thus, the eventual dollar savings are only marginal or entirely illusory. Some scaling back or stretch-outs of major "platform" programs (i.e., tactical aircraft, naval vessels, etc.) can be expected, but vertical program eliminations (entire program cuts rather than portions) will be a more frequently used alternative to reduce costs.
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> A dollar cut in the defense budget does not necessarily suggest an equivalent dollar savings. Only about 15% of the procurement allocation is spent after one year versus 80% of the operations and maintenance (O&M) budget and nearly 100% of personnel expenses. Thus, most of the true saving will come from the O&M and personnel portions.
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> . . . For each program cut, there are likely to be retrofits and upgrades of older systems.

Gramm-Rudman, as the investment firm argues, does not merely hit hardest at the military's capacity to function (personnel and operations and maintenance), but it throws the defense industry into a form of Russian roulette over the elimination of entire weapon-systems programs.

The financial crisis

Between now and Sept. 30, 1986, the end of the current fiscal year, the U.S. Treasury will find perhaps $50 billion in unexpected bills on its doorstep, due to the failure of commercial banks, savings institutions, and federal agencies responsible for farm and real estate debt. These include:

1) **The $80 billion Farm Credit System.** By imposing a draconian liquidation policy for delinquent debtors upon the bankrupt system, the Treasury has ensured that the majority of FCS debtors will have no means to pay any portion of their obligations. The spiral of foreclosures resulting from the Treasury's lunatic approach to the FCS will bring the bailout requirement for the system to the range of $20 billion toward the end of 1986, according to astute farm-sector analysts. Should the Treasury fail to act promptly in support of the FCS, the entire half-trillion-dollar structure of federal "agency" debt will crash, bringing down all the mortgage-market support agencies along with the farm lending agency.

The administration will have little choice. A recent analysis of the banking sector by Prudential-Bache securities wrote, "We believe the administration will cave in partially to the farmers of the politically crucial Midwest, despite the constraints of Gramm-Rudman and the fact that it recently rejected a request by the Farm Credit Administration (FCA) for a $6 billion bailout. We expect a lesser amount, between $3 to $4 billion, could be advanced on a 'needs basis' to the Farm Credit System through bond purchases."

Penny wise, pound foolish, the administration will try to save money in the short term, and allow the farm debt crisis to snowball out of control.

2) **The insolvent Federal Savings and Loan Insurance Corporation.** The FSLIC, which underwrites the deposits of the nation's savings and loan institutions, has available funds of $2 billion. Six hundred of the institutions it supervises are in bad trouble, half of them in extreme duress. According to Prudential-Bache, to resolve only the 12 most pressing cases in California, would cost $4 billion, or twice the resources of the FSLIC. A rash of problems for real estate developers, as anticipated above, would bring the FSLIC's urgent requirents above the $20 billion range. Prudential-Bache suggests that the FSLIC's absorption by the Federal Reserve System might be the "solution of last resort"; the consequences of a $20 billion hole in the Fed's balance sheet may be left to the reader's imagination.

3) **The real estate crisis.** The Government National Mortgage Association has already had to sell hundreds of housing units which it acquired through foreclosure into the depressed Florida real-estate market. For reasons given above, it and other federal agencies which buy packages of mortages from savings banks and re-sell them to institutional investors, will be caught in the middle of the real-estate disaster we anticipate as a result of Gramm-Rudman. The Federal National Mortgage Association, a similar agency, has $92 billion in debt, and only $1.3 billion in capital. Losses in excess of that will presumably be borne by the Treasury.

4) **The Third World debt crisis.** The crash of oil prices has drawn attention to Mexico's $100 billion foreign debt; but the oil price development merely corresponds to a generalized crash in commodity prices which has wiped out the earnings capacity of the entire developing sector. During the 1983-84 round of the debt crisis, the Treasury lent a few billion dollars as "bridging funds," and contributed $6 billion to the International Monetary Fund. The bailout requirements to avert a crash of the Eurodollar market will be several times in excess of that amount.