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REDUCING THE FEDERAL DEFICIT: A CRITICAL CHALLENGE

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It's always a pleasure to visit Los Angeles, and the Town Hall is certainly one of the most prestigious forums in the entire country.

Your inviting me to speak here today tells me one thing: though we may work in different parts of the country--some in private industry and some in government--we are concerned about many of the same issues.

If I asked you to identify the most critical challenge facing the President and the Congress today, I'm sure most--if not all--of you would say the budget deficit. And rightfully so. For the fourth year in a row, that deficit is in the vicinity of 200 billion dollars, and it affects nearly every person in the United States, to say nothing of people abroad.

We have been hearing a lot about deficits and the public debt since the 1984 Presidential campaign. But the problem is not really a new one. We have had a deficit every year since 1970. Although the size has fluctuated, the trend has been for those deficits to get ever larger.

As we entered the 1980s, we had a public debt of about 850 billion dollars. It had taken us about 200 years to reach that level. The debt has now risen to more than 1-1/2 trillion dollars and, if we continue on our present course, it will grow by another trillion before the end of the decade.

I would like to begin today by telling you why I think we cannot afford to let that happen.

WHY THE DEFICIT MATTERS

In simple terms, the deficit matters because it shows that our government is living beyond its means. We--the citizens--

through our elected representatives--are demanding services for which we are unwilling to tax ourselves. There are sound economic reasons for doing that during a recession. But we have been out of the recession for quite a while, so that justification does not carry much weight now.

Continuing an enormous deficit during an economic recovery has serious consequences which will eventually catch up with us. Those consequences may not come as quickly as people thought a couple of years ago, but I am convinced that they cannot be postponed forever.

Typically, as the economy recovers from a recession, the private demand for credit expands. If the government continues to run a deficit, <u>its</u> demand for credit will collide with <u>private</u> demand, forcing interest rates up.

On the surface, this is not what has happened. Interest rates are lower today than they were 4 years ago. For example, the interest rate on 10-year Treasury bonds declined from 15 percent in 1981 to around 12 percent at the end of 1984. More recently, as the economy softened, the rate dropped to around 10 percent. But the inflation rate has dropped from 11 percent in 1981 to around 4 percent today. Thus, real interest rates, adjusted for inflation, are significantly higher today than in 1981.

High interest rates lead to several other problems. Normally, they discourage borrowing for productive domestic capital investment. This, in turn, means there will be slower growth of productive capacity in the future and, consequently, slower growth of the economy as a whole.

Again, the current evidence seems to conflict with this. Investment has been rather robust over the past few years. But I am convinced that this is <u>despite</u> the budget deficit, not <u>because</u> of it.

Relatively high interest rates, along with a number of other factors, have encouraged an enormous influx of foreign capital. These capital flows--equal to half or more of the budget deficit--have moderated the rise in interest rates and, together with business tax cuts and a continuing growth in output, have permitted private investment to continue.

However, these capital flows mean that the rest of the world is financing our current standard of living. Aside from the questionable ethics of having the richest nation on earth live beyond its means on credit supplied by other nations, it seems doubtful that this arrangement will continue forever. The countries from which this capital is coming have their own needs which will not be deferred indefinitely to satisfy our appetites.

The capital flows have been largely responsible for the overvalued dollar, which causes our exports--ranging from heavy capital goods to farm commodities--to be less competitive in world markets. The overvalued dollar also renders our domestic markets much more vulnerable to competition by imports of everything from automobiles to aircraft.

Finally, our high interest rates and heavy capital inflows aggravate the third world debt problem, though these effects are offset to some degree by the increased competitiveness of third world exports to the United States due to the high value of the dollar. Again, our policies aren't totally responsible for the debt problems of other countries. Those countries created most of those problems themselves, with a little help from the banking community. But the economies of those nations and their political and social structures are fragile enough that the last thing they need is additional problems created by unwise American economic policies.

But looking around us, we see an economy which seems strong. Inflation rates and unemployment have declined in a way which seemed impossible only a few years ago. Why should we worry?

First, the economy is less sound than it may look to the casual observer. Consider the rate of bankruptcies; the problems of our banks, savings and loans, and other financial institutions; and the condition of sectors such as agriculture and our basic smokestack industries. These are hardly the signs of a strong and resilient economy.

Second, the economy is showing signs of running out of steam. Growth has slowed, and the leading economic indicators suggest further weakness in the months ahead. The easing of monetary policy in the last couple of months indicates that the Federal Reserve is concerned about the outlook. Whether this means that we are in the early stages of a recession, or only a temporary pause, remains to be seen, but it is hardly an encouraging sign.

Third, the apparent strength of our economy over the past couple of years has been built on borrowed money, and therefore we have been living on borrowed time.

We all know that you can live very well on credit. Sometimes you can live that way for a long time. But eventually there comes a day of reckoning. There's no escaping the fact that what you borrow, you must repay, with interest. And the longer you have lived on credit--and the higher on the hog you have lived--the worse is the day of reckoning. As long as we were only talking about domestic credit, we could afford to talk about it in terms of shifting income among our own citizens. But now we are living on credit from abroad. That means the day of reckoning will involve shifting income from American citizens to people in other nations.

All of us, on the average, may well see our standard of living decline when the day of reckoning arrives.

Recently, I have heard people compare our current situation with that of Great Britain since the end of World War II. Forty years ago, despite the destruction of war, Britain was one of the richest nations in Europe. But, over the years, Britain failed to deal with some basic problems. It repeatedly promised to act on its balance-of-payment deficits, lagging productivity, and high inflation. But because action was so painful, it was repeatedly postponed. Today, Britain has slipped from the top rank of European economic powers. Rebuilding her economy now is proving much more difficult, costly, and painful because action was postponed for so long.

The British experience is very helpful, because it shows what can happen if we postpone tackling the deficit.

Of course we may not have the luxury of postponing the painful adjustment for as long as the British did. Given the fragile condition of the international monetary and financial system, foreign investors could any day and for any number of reasons suddenly decide not to lend us more money. I am not alone in my concern about this situation. Paul Volcker, the Chairman of the Federal Reserve Board, pointed out a year ago that we simply cannot afford to become addicted to drawing on increasing amounts of foreign savings to help finance our internal economy. Although we do not know when, the process will eventually break down.

The instability of international financial markets has been amply demonstrated in recent months. Consider the speed with which foreign deposits were withdrawn from Continental Illinois when it got into trouble, or the quick drop in the value of the dollar when reports circulated about a run on a few Ohio savings and loan associations.

Unimaginable as it may seem for the richest nation on earth, we could find ourselves in an international debt crisis caused by economic mismanagement of the sort we thought was reserved only for third world countries.

I hate to think of the implications of such a crisis for our own economy or that of the entire western world.

It's much better to solve the problem now, rather than try to postpone it. That means tackling the deficit and tackling it as the highest priority objective of the federal government.

HOW TO DEAL WITH THE DEFICIT

If we are to get serious about cutting the deficit--and I have told you why I think we must--the first step is to face the fact that there are no easy, painless ways of doing it.

First, we can't do it by just eliminating fraud, waste, and abuse, as some, such as the Grace Commission, would have us believe.

Four years ago, my predecessor, Elmer Staats, spoke here in one of his final public appearances as the incumbent Comptroller General. His subject was "Fraud, Waste, and Abuse and the Federal Government." I'd like to recall some of his words:

> "There are those who naively believe that the effective elimination of this problem in our society would be a panacea for all of our national ills. The reality, of course, is that this is a utopian dream..."

We should go after inefficiency with a vengeance, but we shouldn't kid ourselves. Eliminating it will make only a modest contribution to closing the deficit.

Second, we can't do it by just cutting other people's programs. Anyone who puts a budget together learns a central fact of life. Someone receives every dollar the government spends--and wants to go on receiving it. Again, I would like to recall the words of Elmer Staats, spoken here 4 years ago: "One person's definition of waste is another's definition of absolute necessity."

Third, once we start to cut the deficit, the miracle of compound interest begins to work for us, rather than against us.

Last summer, in the Brookings Review, Alice Rivlin, the distinguished former director of the Congressional Budget Office, pointed out that each year we postpone action on the deficit adds 200 billion dollars to the debt and increases required annual interest payments by 20 billion dollars. On the other hand, "a one billion dollar expenditure cut would reduce the annual deficit after five years by a total of 1.7 billion dollars--a figure that reflects an additional savings of 700 million dollars in interest payments."

Cutting the deficit to tolerable dimensions will involve considerable pain and sacrifice but, the sooner we start, the less pain there will be in the end. Everyone must accept--and be seen to accept--a part of the burden. This means that no program category or economic section can be exempt:

--Defense, representing almost a third of the budget, cannot be exempt.

--Social security and Medicare, representing another third or so, cannot be exempt.

--Tax revenues cannot be exempt.

Any interest group that tries to escape sharing the burden may risk destroying the consensus for any solution at all.

We must solve this problem together. If not, we face the possibility of having a solution imposed upon us by people in other nations who are concerned more about protecting themselves than about the welfare of Americans.

I am so concerned about the urgency of dealing with the deficit that I have made it the central message of my annual report to the Congress that was issued in January. In that report I said reducing the deficit is the most critical challenge facing Congress and the President--and the most difficult. Meeting that challenge means making hard choices involving the defense budget, domestic programs, and taxes.

In the last few weeks, the Senate and the House have each passed budget resolutions. Those resolutions reflect many of the elements of the strategy I have just outlined. It seems very clear to me that both houses of the Congress are sincerely committed to doing something to reduce the budget deficit. But they differ a great deal in how they would achieve that.

If implemented, either version would try to restrain the rate of growth of the defense budget. But as you are no doubt aware, the House version would make sharper cuts in the defense budget than would the Senate version. And only the Senate version would limit the inflation adjustment for Social Security benefits.

These differences reflect, in part, the partisan alignments of the two houses and are accentuated by the prospects of the 1986 elections. Reconciling those differences will be very difficult, but I am hopeful that the Senate and the House can overcome their differences because of the urgency of the task and its vital importance to the Nation.

The action so far represents real progress, and we should all applaud it. But the passage of a budget resolution is only the first step in a long process. The resolution itself is only a statement of intention. The deficit won't be reduced by a single dollar unless those intentions are translated into actions--changes in laws and appropriations. <u>Those actions have not yet been taken</u>. Because those implementing actions must be very specific to be effective, accomplishing them will be even more difficult than agreeing on a budget resolution, much of which is stated in very general terms.

And this year's resolution, and implementing actions, must be followed by more action next year. Even with the difficult cuts implied by this year's resolution, the deficit will be left unacceptably large, and I must warn you that even a pause in growth, to say nothing of a recession, would cause the deficit to increase rapidly. If the current slowdown were to continue through next year, for example, it could easily add $50 billion or more to the deficit.

Thus, even under the best of circumstances, the process of agreeing on further large spending cuts will need to be repeated several years in a row before we can realistically say that the deficit is under control.

I, myself, am doubtful that the deficit _can_ be controlled by concentrating exclusively on the spending side of the budget. The cuts this year, difficult as they have been, are easy compared to what will be necessary next year, and the year after. That is why I am convinced we must--and will--find an acceptable way of restoring the revenue base.

HOW DO WE PREVENT IT FROM HAPPENING AGAIN?

Because I believe we will solve the problem of the deficit, I also believe we should start thinking now about how we keep the same thing from happening again.

In this case, we don't need to turn to the British for ideas; we can learn a lot from the experience of our own cities and states. And the first lesson is that to prevent a problem, you need to know it's coming. Specifically, to prevent financial problems, you need reliable, timely, and relevant financial information.

In 1975, New York City faced a financial crisis. It had been living beyond its means for more than a decade, financed by a rapidly growing volume of short-term debt. Financial analysts had been expressing concern, but no one in city government took those warnings very seriously. Then, one day, the financial markets simply refused to accept any more paper issued by the city, and the day of reckoning had arrived.

The city couldn't pay its bills and was faced with the very real prospect of bankruptcy. When New York State tried to help, the threat of bankruptcy spread to it, as well.

I was involved in the efforts to deal with the New York City financial crisis, so I have a pretty good understanding of what happened. At the heart of the problem, of course, were a number of unwise policies that led New York to try to live beyond its means. But underlying those unwise policies was the fact that the government of New York did not really know its own financial condition.

Bad financial management systems permitted the city to ignore a growing set of problems until those problems became so large that others--the investors--forced them to be solved.

Indicative of the bad state of affairs is the fact that, even after the crisis arrived, it took the state a year to find out how much debt it owed. In the city, it was even worse. Although the city government published an annual report an inch thick, not even the accountants could make sense of the numbers. No one could even reconcile the cash, for which the budget office and the comptroller's office carried different numbers.

In the final analysis, the city and state--with a lot of help from the federal government--began to deal with the crisis.

The city changed policies to reduce the operating deficit, and, while New York City may not be truly out of the woods yet, the worst of the crisis has passed. In the process of dealing with that crisis, both New York City and State learned a very powerful lesson--and that is the value of having reliable, relevant, and timely financial information.

One of the first things the city did--in the depths of the crisis, and admittedly with a fairly strong push from the federal government--was to start overhauling its financial management systems. The city now has access to a steady flow of good financial management information as a reliable basis for decision-making and annually publishes financial statements audited and prepared according to generally accepted accounting principles.

A number of cities and states have learned a lesson from the New York City fiscal crisis and have overhauled their own financial management systems. I've often said that the New York City crisis was to our public sector what the crash of 1929 was to our private sector. In both cases, financial crises led to massive reform of financial management and financial reporting.

Other nations, including those going through the international debt crisis, are learning the lesson too. One of the first things many of them discovered in their crisis was that they didn't know how much debt they owed, who owed it, and to whom.

Let me tell you--from talking to some of my counterparts in those countries--that can be a very frightening experience.

My Canadian counterpart, Ken Dye, is hard at work developing a revised set of consolidated financial statements for the Canadian national government. He was given this responsibility by a government and Parliament which came to see the inadequacies of the present statements. We are cooperating with this Canadian effort and expect to learn a lot from it.

The time has come for our federal government to learn the lesson, too. We must realize that our government--facing 200 billion dollar deficits--is not immune from crisis. It must put its financial house in order. That means adopting policies which will permit us to live within our means. But it also means having the reliable and relevant information to understand the issues and make good decisions.

If decision-makers and the public are to have the information they need to recognize and solve problems before the crisis stage, we must start now to overhaul our financial management systems. Those systems, many of which were originally designed during World War II, are simply inadequate for today's needs.

Let me give you an example of what this means. There is a report called the Selected Acquisition Report--SAR for short--which DOD sends to the Congress annually. In concept, it is very good. It is supposed to tell the status of each major weapons system in the DOD program in terms of cost, schedule, and technical performance. But the cost data comes from memorandum records, not the accounting system, and it ties to the budget only once a year. So what happens over time is that program managers--or others in the chain of command--conceive of better ways to present the information and, in the process, change the numbers. The numbers often have no credibility because they have no base in the accounting systems.

Let me give you another example. During the late 1970s, we had a series of budget projections that led policymakers to believe that each year's deficit was temporary. If we looked at the projections for 3 years ahead, it was always possible to conclude that the deficit would disappear without our having to do anything about it. We now know how wrong those projections were. Much of that failure came from what we now recognize were overly optimistic assumptions about how the economy would perform, and I don't want to minimize that aspect of the problem.

But the problem also grew out of the lack of reliable information about the costs and results of ongoing federal programs. Without that information--which can only come from good financial management systems--it is extremely difficult, if not impossible, to develop reliable estimates of future requirements.

I am convinced that we can build the systems we need to provide reliable, relevant, and timely information about our financial condition. And I am also convinced that we need such systems to prevent the kind of deficit we face today. GAO has recently published a report, Managing The Cost of Government: Building an Effective Financial Management Structure, which suggests ways in which we might begin that task. It will not be easy and it will not be cheap, but the effort and the cost will be a lot less than if we don't do it at all.

I'd like to close by showing that the need for sound financial systems goes back as far as 1802 when Thomas Jefferson wrote to the Secretary of the Treasury, Alexander Hamilton, about the quality of financial information in the federal government. He said, in part:

> "I think it an object of great importance...to simplify our system of finance...we might hope to see the finances of the union as clear and intelligible as a merchant's books, so that every member of Congress...should be able to comprehend them to investigate abuses, and consequently to control them."

We are no closer to that goal than we were in Jefferson's day. But I am happy to adopt Thomas Jefferson's goal as my own, and I plan to spend much of my term of office pursuing it. I would certainly welcome your support.