US Federal Budget Restraint in the 1990s: A Success Story

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David R. Henderson. "US Federal Budget Restraint in the 1990s: A Success Story." Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, June 2015.

ABSTRACT

Many observers think that it is impossible to cut federal government spending as a percentage of Gross Domestic Product (GDP). But it can be done. And the evidence is hidden in plain sight: it's called the 1990s. Between 1990 and 2000, federal spending fell from 21.85 percent of GDP to 18.22 percent, a drop of 3.6 percentage points. Most of the reduction was in defense spending after the Cold War ended. Domestic spending also fell slightly as a percentage of GDP. This drop cannot be attributed to higher economic growth in the 1990s because average growth in the 1990s was the same as growth in the previous two decades.

JEL codes: H2, H5

Keywords: budgets, taxes, federal spending, defense, domestic, debt

Release: June 2015

INTRODUCTION

Canada's Budget Triumph," a Mercatus study that I wrote in 2010,[1] documented the budget cuts that Canada's federal government undertook from 1994 to the early 2000s. This sentence from my study sums up one of its key messages: "The result of years of cuts in government spending was that, as a percentage of GDP, federal spending on programs [as distinct from interest on the federal debt] fell from a high of 17.5 percent in 1992–93 to 11.3 percent in 2000–01."

This is a reduction of 35.4 percent in the percentage of GDP that Canada's federal government spent on government programs. That is an astounding number. These budget cuts turned government deficits into surpluses, dramatically reduced federal government debt as a percentage of GDP, and did not appear to hurt —and probably helped—economic growth.

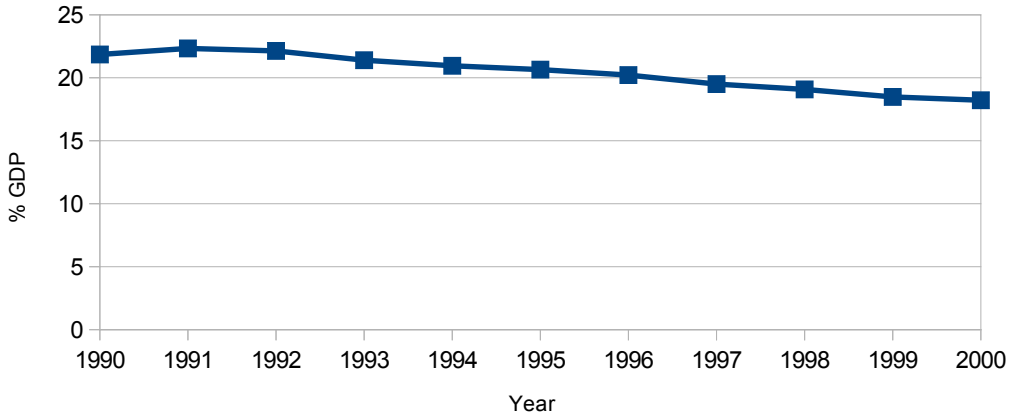
Can we do it here? To some extent, we did do it here.

Many Americans worry that the difference in political systems makes it more difficult to reduce government spending. And it does. Canada has a parliamentary system in which the executive branch and the legislative branches are one, whereas the United States has a system in which the executive and legislative branches are separate. This means that once the executive branch in Canada decides to cut spending, it will cut spending. There is no conflict between the legislature and the executive because they are one and the same. In the United States, by contrast, a Congress that wants to cut spending but gets little support from the president is unlikely to get large cuts and a president who wants to cut spending but gets little support from the Congress is unlikely to get large cuts.

But the difference in political systems means that cutting spending as a percentage of GDP in the United States is harder to do than in Canada, not that

1. David R. Henderson, "Canada's Budget Triumph" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, September 2010), http://mercatus.org/publication/canada-s-budget-triumph.

FIGURE 1. FEDERAL SPENDING AS PERCENTAGE OF GDP



Source: Unless otherwise noted, all spending data come from Office of Management and Budget, "Historical Tables," http://www.whitehouse.gov/omb/budget/Historicals.

it's impossible to do. The evidence that it can be done is right under our noses: it's called the 1990s.

In 1990, government spending on programs and interest on the federal debt was 21.9 percent of GDP. By 2000, as figure 1 shows, it had fallen to 18.2 percent of GDP, a reduction of 3.6 percentage points. That amounts to a substantial 17 percent reduction in the share of GDP spent by the federal government. While this is a more modest reduction than that achieved by the Canadian government, a one-sixth reduction in the government's share of GDP is economically significant.

How was this reduction achieved? One might expect that, given the Canadian example, it happened because a president and a Congress of the same party agreed to cuts. But that's not mainly what happened. Instead, the cuts occurred fairly steadily through the 1990s, first with a Republican president George H. W. Bush and a Democratic Senate and House of Representatives from 1990 to January 1993, then with a Democratic president William Clinton and Democratic Senate and House from January 1993 to January 1995, and finally with a Democratic president William Clinton and Republican House and Senate from January 1995 to the end of 2000. In short, for only two of the ten years in the 1990s were the Congress and the president from the same party.

Moreover, these cuts in government spending, most of which occurred in the first half of the 1990s, did not seem to lead to an increased unemployment rate. In fact, the unemployment rate, after peaking in 1992, fell steadily through the rest of the 1990s.

What are the lessons from the 1990s for today? As we shall see, it's complicated. It would be difficult to make, in the next few years, the same kinds of changes to the budget like the ones that were done in the 1990s, because the sizes of the various components of the budget have changed. Specifically, the defense budget as a percentage of GDP is smaller than it was in the early 1990s. Also, we are now in a period when the retirement of the baby boomers will increase Social Security and Medicare spending as a percentage of GDP, something that did not happen in the 1990s. Yet the 1990s should give us some hope—politically and economically. The political hope is that politicians from both major parties can occasionally come together to cut budgets. The economic hope, based on evidence, is that politicians can cut budgets without increasing unemployment.

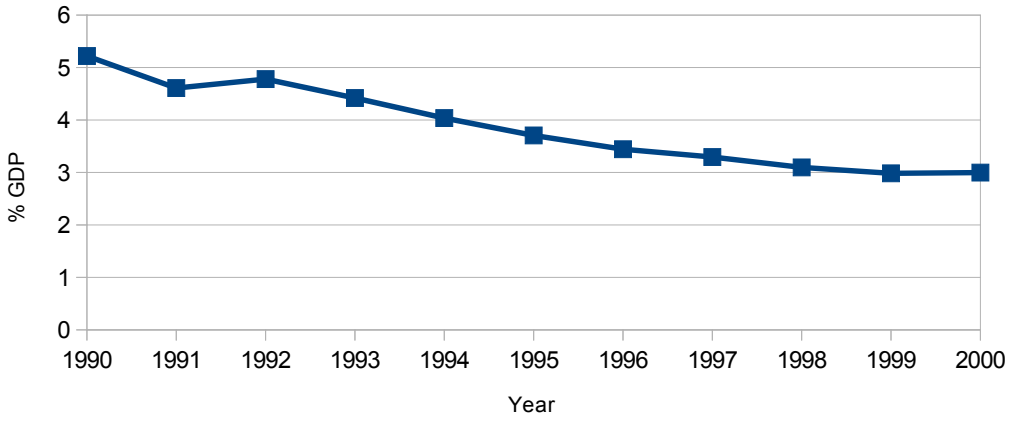
WHERE THE CUTS OCCURRED

When analysts refer to government budget cuts, they do not all use the word "cut" the same way. A cut in government spending can mean one of four things: a cut in the dollar amount of spending; a cut in real spending, that is, an inflation-adjusted cut; a cut in spending as a percentage of GDP; or a cut in the planned increased in spending. Unless otherwise stated, when I refer to cuts in federal spending, I will mean a cut in spending as a percentage of GDP.

Cuts in federal spending occurred in two main areas: defense spending and net interest on the US federal debt. Spending fell slightly as a percent of GDP in a third area, domestic spending. Within that third category, we must, as will be shown below, distinguish between so-called mandatory spending and discretionary spending. Mandatory spending, which is not really mandatory, is the term used for spending that occurs if Congress does not act to change it. The biggest programs that involve mandatory spending are Medicare, Social Security, and Medicaid. Discretionary spending is spending that occurs only if Congress acts to pass new laws that require that spending.

Most of the cuts occurred in defense spending. During president George H. W. Bush's first year in office, the Berlin Wall fell, essentially signaling the end of the Cold War. In response, Bush and Congress started implementing substantial cuts in military spending as a percentage of GDP. When Clinton came into office in January 1993, he kept on the glide path that Bush and Congress had put in place. The result was that defense spending actually fell in nominal terms, from $299.3 billion in 1990 to $294.5 billion in 2000. As figure 2 shows, defense spending fell from 5.2 percent of GDP to 3.0 percent. Cuts in defense spending accounted for 61.2 percent of the overall reduction in federal

FIGURE 2. DEFENSE SPENDING AS PERCENTAGE OF GDP



spending. Most of the glide down had occurred by fiscal year (FY) 1998, when defense spending reached 3.1 percent of GDP.

The other major category in which spending fell as a percentage of GDP was the federal government's net interest on the federal debt. As economic growth and restraint on program spending (federal spending that is not interest on the debt) kicked in, net federal debt peaked in 1993 at 49.5 percent of GDP and then fell to 35.1 percent of GDP by 2000. With a lower debt-to-GDP ratio, interest payments on the debt were lower as a percentage of GDP, making the debt-to-GDP ratio shrink further. As figure 3 shows, net interest on the federal debt fell from 3.2 percent of GDP in 1990 to 2.3 percent of GDP in 2000, a fall of 0.9 percentage points, which is 25.9 percent of the overall reduction in federal spending as a percentage of GDP.

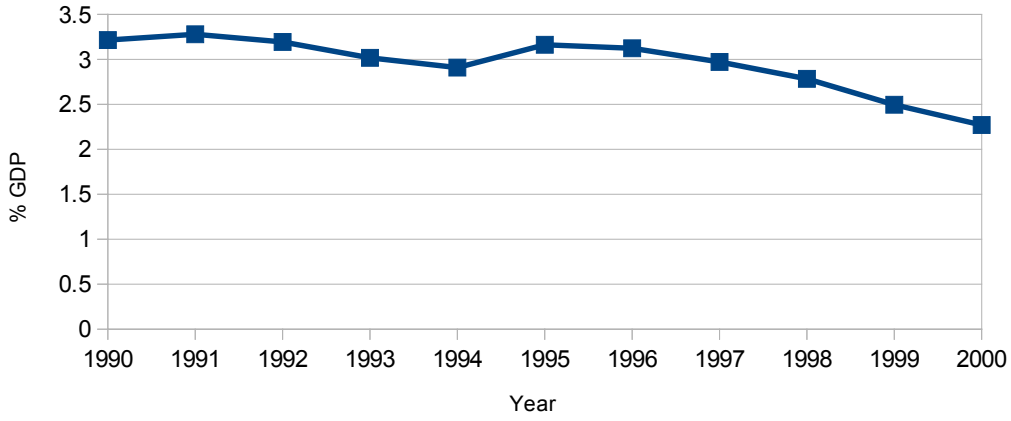
Domestic spending fell slightly as a percentage of GDP. Domestic spending, which I define as total government spending, minus net interest on the federal debt, minus defense spending, minus spending on international affairs, fell from 13.2 percent of GDP to 12.8 percent of GDP, a drop of 0.4 percentage points. This was 11.0 percent of the overall reduction.

Let us consider each category in more detail.

Defense Spending: The Peace Dividend

The Soviet Union ceased to exist on, somewhat appropriately, Christmas Day, 1991. Even before that happened, the fall of the Berlin Wall in November 1989 presaged the collapse of that evil empire. Together with Congress, president George H. W. Bush, who entered office just ten months before the fall of the wall, recognized that the Cold War with the Soviet Union was over and began

FIGURE 3. NET INTEREST AS PERCENTAGE OF GDP



a process of partial demobilization. Even president Ronald Reagan, a strong advocate of the military buildup of the early 1980s, had, late in his time as president and along with Congress, started slightly reducing the percentage of GDP spent on the military.

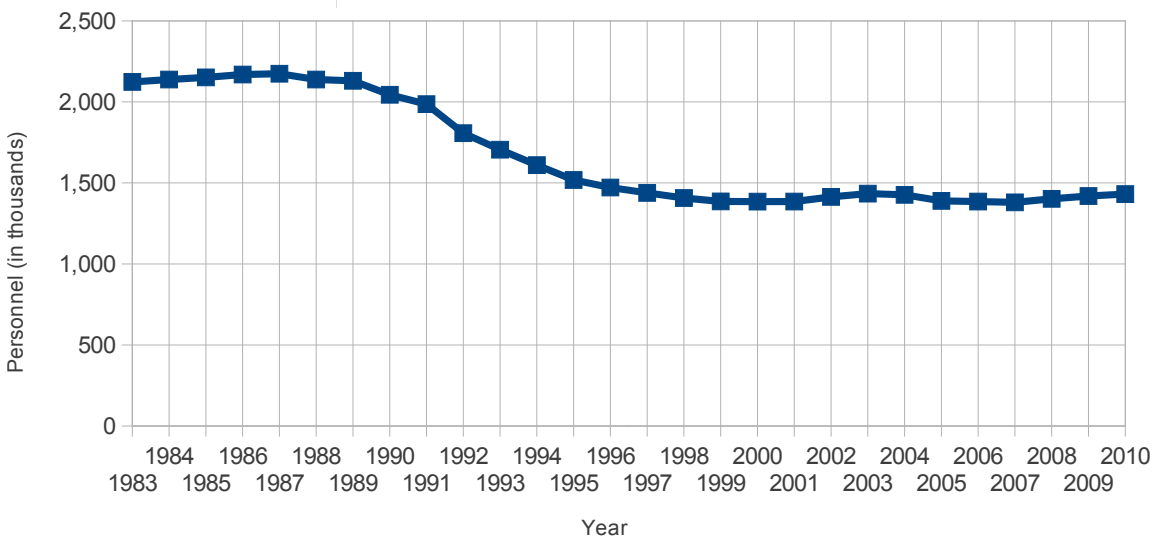
President Bush, his secretary of defense Dick Cheney, and Congress put defense spending on a slight downward glide path, so that through the 1990s, defense spending as percentage of GDP fell. When president Clinton took office, he did little to change that glide path.

As noted above, between 1990 and 2000, defense spending actually fell in nominal terms, from $299.3 billion in 1990 to $294.5 billion in 2000. Over that same period, the Consumer Price Index (CPI) increased by 32 percent and the GDP deflator, the other common price index used to measure inflation, increased by 23 percent. Therefore, defense spending, adjusted for inflation, fell by 25 percent (using the CPI measure of inflation) or 20 percent (using the GDP deflator to measure inflation).

One of the major areas where the decline occurred was in the number of people in uniform. As figure 4 shows, after the size of the military reached a peak of 2,174,000 personnel in 1987, it fell gradually in Reagan's last full year in office and during Bush's first three years in office.[2] And in 1992, his last full year in office, Bush reduced the size of the military by 189,000, from 1,986,000 to 1,807,000, a drop of 9.5 percent in one year. From 1992 to 1993, the size of the military fell by another 102,000, a drop of 5.6 percent. One might think this last

2. US Department of Defense, DOD Personnel, Workforce Reports & Publications, "Active Duty Military Strength by Service: Historical Reports—FY 1954–1993," accessed May 23, 2015, https://www.dmdc.osd.mil/appj/dwp/dwp_reports.jsp. All data on the number of uniformed personnel in the US military are for the end of the fiscal year, which is September 30.

FIGURE 4. DEPARTMENT OF DEFENSE UNIFORMED MILITARY PERSONNEL: 1983–2010



drop was attributable to newly elected president Bill Clinton, but because the data are for fiscal years, the end strength number of 1,705,000 was reached on September 30, 1993, only eight months after Bush left office. The drop in numbers was therefore attributable mainly to Bush. Personnel continued to decline under president Clinton, although more slowly, reaching its nadir in 2000 of 1,384,000 people. That was a further drop of 18.2 percent over seven years.

This decline in military personnel led, quite naturally, to a decline in payments to the military. Peak spending on military personnel in the 1990s was in 1991, probably owing to the fact that the military was engaged in the first Gulf War and payments to the military (combat pay, etc.) are higher during war. In 1991, the federal government paid $83.4 billion to uniformed personnel, and by 1998, this had fallen to its 1990s low of $69.0 billion. Adjusted for inflation, the number was even lower.

Other parts of the military also shrank. Consider navy ships.[3] The number of US Navy ships reached a post–Vietnam War low of 521 in September 1981, the first year of the Reagan administration. Reagan promised a 600-ship navy and almost kept that promise. In 1987, the second to last full year of his administration, the US Navy had 594 ships. After 1989, the number of ships decreased, from 592 in 1989 to 318 in 2000. Ships include a wide range of vessels. The number of submarines, for example, which had bottomed out at 73 in

3. US Navy, Naval History and Heritage Command, "US Ship Force Levels: 1886–present," http://www.history.navy.mil/research/histories/ship-histories/us-ship-force-levels.html.

1974, reached its peak at 102 in 1987. That number fell from 99 in 1989 to 56 in 2000. The number of aircraft carriers hardly changed. From a post-Vietnam low of 12 in 1981, the number of aircraft carriers rose to 15 in 1991 and then fell to a still-hefty 12 in 1994. It remained at 12 throughout the 1990s and early 2000s.

Also, the number of army divisions, which was 18 from 1986 to 1990, was cut to 16 in 1991, to 14 in 1992, to 12 in 1994, and then to 10 for the rest of the 1990s and into the next century. This sounds drastic, but recall that one of the major justifications for such a large army was to defeat the Soviet Union in a conventional land war in Europe. With the Soviet Union gone and Russia, the only plausible land-war threat, weakened, it made sense to downsize.

Given the increase in defense spending in real terms and as a percentage of GDP since 2000, one place to look for large budget cuts is defense. That immediately raises the issue, of course, about whether substantial cuts, on the order of 1 percent of GDP, would be a good idea now. One way to approach the issue is to ask whether defense was cut too much in the 1990s so that the government was left unprepared when terrorists attacked on September 11, 2001.

One could argue that the US government would have been better prepared had there been more people trained in the languages of the Middle East. Yet it is difficult to point to a military operation that should have happened but did not because not enough US military personnel knew the relevant languages.

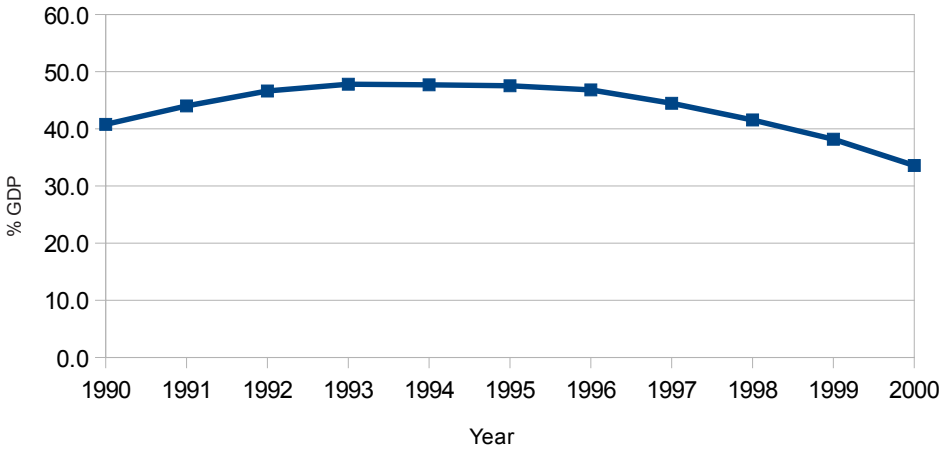
Second and related, the reduction in military spending and military manpower in the 1990s still left the US government with by far the most powerful military in the world and able to engage in two major wars, one in Afghanistan in 2001 and one in Iraq in 2003.

Interest on the Debt

Net interest on the federal government's debt was the second most important category in which spending as percentage of GDP fell. As noted, between 1990 and 2000, it fell by 0.9 percentage points. In 1990, net interest on the federal debt as a percent of GDP was 3.2 percent. It peaked at 3.3 percent in 1991 and fell throughout the 1990s, hitting 2.3 percent in 2000, 0.9 percentage points lower than it had been ten years earlier. Two factors contributed to this fall: the decline in the debt and the decline in nominal interest rates on the debt.

Although the large deficits of the early 1990s caused net debt to grow as a percentage of GDP, from 42.0 percent of GDP in 1990 to 49.5 percent in 1993, declining deficits caused the debt-to-GDP ratio to fall after 1993. By 1997, the

FIGURE 5. NET FEDERAL DEBT AS PERCENTAGE OF GDP



debt had fallen to 46.1 percent of GDP. When small federal budget deficits gave way to small surpluses in 1998, the debt fell to 42.9 percent of GDP and then, with continuing budget surpluses, fell to 39.8 percent of GDP in 1999 and 35.1 percent of GDP in 2000.

Although it may be hard to believe now, at the end of the decade, serious observers, anticipating a string of future federal budget surpluses, thought that the net federal debt would ultimately fall to zero. Testifying in January 2001, Alan Greenspan, then chairman of the Board of Governors of the Federal Reserve System, stated: "The most recent projections from the OMB indicate that, if current policies remain in place, the total unified surplus will reach $800 billion in FY 2011, including an on-budget surplus of $500 billion. CBO reportedly will be showing even larger surpluses."[4] Greenspan went on to say that "the most recent projections, granted their tentativeness, nonetheless make clear that the highly desirable goal of paying off the federal debt is in reach before the end of the decade." Of course, the Office of Management and Budget's, the Congressional Budget Office's (CBO), and Greenspan's predictions turned out to be wildly optimistic.[5]

The other factor in declining net interest on the federal debt was the decline in interest rates on the debt. Although the federal government, surprisingly, does not report the average interest rate on the federal debt, we

4. *Outlook for the Federal Budget and Implications for Fiscal Policy: Hearing before the US Senate Committee on the Budget* (January 25, 2001) (testimony of Alan Greenspan, chairman, Board of Governors of the Federal Reserve System), http://www.federalreserve.gov/BOARDDOCS/TESTIMONY/2001/20010125/default.htm.

5. The main reason is that after 9/11, both president George W. Bush and Congress abandoned budget restraint, initiating two expensive wars and the Medicare Part D program to subsidize prescription drugs for seniors. I am indebted to Patrick Knudsen for this point.

can compute it by dividing the net interest paid by the federal government each year by the net federal debt of that year.

Table 1 shows net interest, net debt, the average interest rate, and net interest as a percentage of GDP for the years from 1990 to 2000. During the last half of the 1990s, from 1995 to 2000, net interest as a percentage of GDP fell substantially, from 3.16 percent in 1995 to 2.27 percent in 2000. Yet during those years, the average interest rate bounced around and actually rose from 7.44 percent in 1995 to 7.63 percent in 2000. Net debt, on the other hand, although it bounced around also, actually fell from $3.604 trillion in 1995 to $3.410 trillion in 2000. In other words, the drop in interest on the debt as a percentage of GDP was not primarily attributable to the drop in interest rates. Instead, the decline in interest was attributable to a drop in the debt—and to a high growth rate of GDP in the last half of the 1990s.

TABLE 1. NET INTEREST, NET DEBT, AVERAGE INTEREST RATE, AND NET INTEREST AS A PERCENTAGE OF GDP FROM 1990 TO 2000

Year	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Net interest on the federal debt (billions)	$204.3	$223.1	$232	$235.8	$244	$268	$274.4	$275.3	$278.8	$263.1	$260.1
Net debt held by the public, end of year (billions)	$2,411.6	$2,689	$3,000	$3,248.4	$3,433	$3,604.4	$3,734.1	$3,772.3	$3,721.1	$3,632.4	$3,409.8
Average interest rate	8.472%	8.297%	7.743%	7.259%	7.107%	7.435%	7.349%	7.298%	7.492%	7.243%	7.628%
Net interest as a percentage of GDP	3.215%	3.279%	3.194%	3.017%	2.909%	3.162%	3.123%	2.971%	2.783%	2.495%	2.270%

Sources: Chairman of the Council of Economic Advisers, *Economic Report of the President* (2003) (Washington, DC: Government Printing Office, February 2003); net interest from OMB historical tables, GDP from FRED (GDP is end of year).

If we are to take the past as a guide to the future, this fact is very good news because, with interest rates at or close to historical lows, we cannot rely on lower interest rates in the future.

Domestic Spending: The Dog that Didn't Bark

As noted above, from 1990 to 2000, domestic spending fell slightly from 13.2 percent of GDP to 12.8 percent of GDP, a drop of 0.4 percentage points. In "Silver Blaze," a short story by Sir Arthur Conan Doyle, Sherlock Holmes figures out that a key clue is that a dog did not bark. The striking thing is not that domestic spending fell only slightly as a percentage of GDP. The striking thing is that it did not rise. This absence of a rise is the dog that didn't bark.

This drop in domestic spending as a percentage of GDP does not appear

large—indeed, it is small. But this spending includes so-called mandatory spending, the bulk of which is spent on Medicare, Medicaid, and Social Security. And there were pressures in these programs, especially in Medicare and Medicaid, for higher spending. In the case of Medicaid, various budget deals from the mid- to late-1980s between president Reagan's staff and southern California Democratic congressman Henry Waxman expanded eligibility for Medicaid in the future in return for modest tightening in the present. Not surprisingly, therefore, Medicaid spending rose throughout the first half of the 1990s, from 0.7 percent of GDP to 1.2 percent of GDP in 1995. It then stayed relatively flat, ending at 1.2 percent in 2000.

Medicare spending rose from 1.7 percent of GDP in 1990 to a peak of 2.3 percent in 1997, and then fell to 2.0 percent by 2000. In sum, therefore, federal spending on Medicare and Medicaid rose from 2.43 percent of GDP in 1990 to 3.21 percent in 2000. One reason for the fall in Medicare spending as a percentage of GDP in the late 1990s, besides the booming economy, is that Congress and the president managed to make reforms to Medicare.[6]

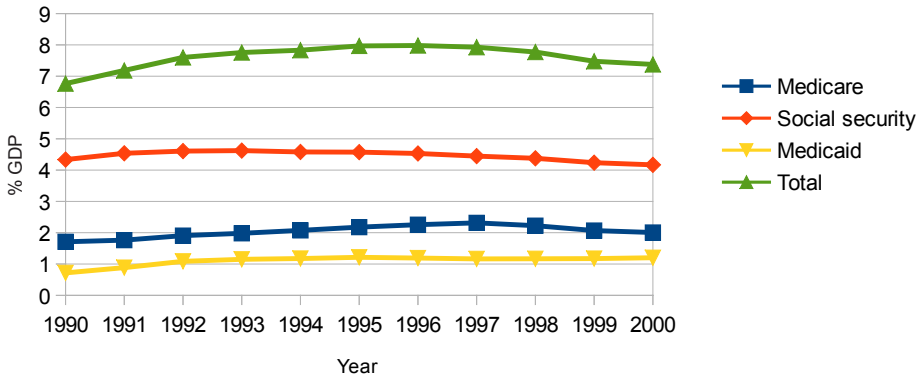
Spending on Social Security, the largest of the three programs, rose from 4.3 percent of GDP in 1990 to a peak of 4.6 percent in 1993 and then fell through the rest of the 1990s to 4.2 percent of GDP. It should be noted, though, that this slight decline was owing mainly to demographic factors—the baby boomers had not yet started retiring—rather than to changes in government policy. That is relevant because those demographic factors will not repeat themselves in the next few decades. Baby boomers, after all, are retiring.

Spending on Social Security, Medicare, and Medicaid combined rose from 6.8 percent of GDP in 1990 to 7.4 percent in 2000, an increase of 0.61 percent of GDP. That increase of 0.6 percent of GDP makes the overall drop in domestic spending of 0.4 percent of GDP all the more striking. The necessary implication is that domestic spending, aside from spending on Social Security, Medicare, and Medicaid, fell by 1 percent of GDP. Specifically, it fell from 6.4 percent of GDP in 1990 to 5.4 percent in 2000.

Why did this happen? There were two factors. One was the "Perot vote"

6. For more on these reforms, see James R. Horney and Paul N. Van de Water, "House-Passed and Senate Health Bills Reduce Deficit, Slow Health Care Costs, and Include Realistic Medicare Savings," Center on Budget and Policy Priorities, December 4, 2009. Box 2 lists various cuts in the Balanced Budget Act of 1997. Here is an excerpt: "CBO estimated that the Balanced Budget Act of 1997 reduced the deficit by $127 billion over five years (FY 1998–2002). Medicare savings accounted for $116 billion of this amount. Over ten years, Medicare accounted for $394 billion of the bill's $402 billion in mandatory savings. The legislation contained numerous provisions to slow Medicare costs, such as reducing the prices that fee-for-service providers received per unit of service, maintaining Part B premiums at 25 percent of the cost of services rather than allowing premiums to decline as a share of the costs, and slowing the growth in payments to capitated plans."

FIGURE 6. SOCIAL SECURITY, MEDICARE, AND MEDICAID SPENDING AS A PERCENTAGE OF GDP



in the 1992 presidential election. The other related factor was the so-called Republican Revolution of 1994.

In 1992 Ross Perot, running as an independent, won 18.9 percent of the vote for president. This was the largest percentage a third-party candidate had received since Teddy Roosevelt in 1912. At one point in June 1992, Perot had led Gallup's presidential poll with 39 percent versus 31 percent for Republican incumbent George H. W. Bush and 25 percent for Democrat challenger Bill Clinton.[7] Perot badly botched his campaign after that, but there is little doubt that Bill Clinton, who won the election with just 43 percent of the vote, noticed that Perot had harped on the budget deficit, which seemed to have caught fire with the electorate.[8] Indeed, *Washington Post* reporter Bob Woodward tells how Bill Clinton "got religion" on reducing the deficit.[9]

But President Clinton's 1993 Omnibus Budget Reconciliation Act attacked the deficit mainly with tax increases. Altig and Gokhale estimated at the time that 56 percent of the total deficit reduction for FY 1994 to FY 1998, relative

7. "The 1992 Campaign: On the Trail; Poll Gives Perot A Clear Lead," *New York Times*, June 11, 1992, http://www.nytimes.com/1992/06/11/us/the-1992-campaign-on-the-trail-poll-gives-perot-a-clear-lead.html.
8. According to a poll by Voter Research and Surveys, 42 percent of Perot voters stated that the federal deficit was the issue that mattered most in their decision to vote for Perot. This was second behind the 53 percent of Perot voters who said that "economy/jobs" mattered most in their decision. See Steven A. Holmes, "The 1992 Elections: Disappointment," *New York Times*, November 5, 1992, http://www.nytimes.com/1992/11/05/us/1992-elections-disappointment-analysis-eccentric-but-no-joke-perot-s-strong.html.
9. Bob Woodward, *The Agenda: Inside the Clinton White House* (New York: Simon & Schuster, 1994).

to the baseline, was in the form of increased revenues.[10] Clinton and Congress raised the top marginal tax rate on individual income from 31 percent to 39.6 percent, raised income taxes on higher-income Social Security recipients, and raised the gasoline tax by 4.3 cents per gallon. Also, the majority of spending cuts—60 percent—were deferred to FY 1997 and FY 1998.

Given the Clinton administration's focus on tax increases and the backloaded nature of the spending cuts,[11] the main factor in reducing domestic spending as a percentage of GDP was the Republican congressional victories in the November 1994 elections, when Republicans won control of both the House of Representatives and the Senate. Newt Gingrich, as Speaker of the House, pushed hard for restraint in the growth of domestic spending. To some extent, Gingrich and the Republicans succeeded. They did not eliminate whole departments or even substantially cut large parts of domestic spending. Instead, in some areas they held the line on spending and even achieved small cuts. Their signature achievement, in advance of the 1996 presidential election, was welfare reform.

The political hope is that politicians from both major parties can occasionally come together to cut budgets.

Here's how Robert D. Reischauer, the Director of the CBO from 1989 to 1995 and president of the Urban Institute from 2000 to 2012, summed up the Republicans' achievement:

> Although the ambitious budget agenda of the 104th Congress was not fulfilled, the Republicans did force the president to accept a modest amount of deficit reduction in the form of lower spending. Discretionary spending was cut below the 1990 Budget Enforcement Act caps through rescissions

10. David Altig and Jagadeesh Gokhale, "The Budget Reconciliation Act of 1993: A Summary Report" (Economic Commentary, Federal Reserve Bank of Cleveland, October 15, 1993), http://www.clevelandfed.org/Research/commentary/1993/1015.pdf.
11. Some of these "cuts" were merely reductions relative to the baseline, achieved by extending policies from the 1990 Budget Enforcement Act.

of fiscal 1995 appropriations and the regular fiscal 1996 and 1997 appropriations. Discretionary budget authority and outlays for fiscal 1997 are some 5.0 percent and 1.8 percent, respectively, below the Budget Enforcement Act limits. The welfare reform legislation enacted in August 1996 will reduce spending on affected programs by an estimated $54 billion over 1997–2002. In addition, the farm bill that was enacted in early 1996 should reduce expenditures over this period by $2 billion, even though it increases spending in 1996 and 1997.[12]

ECONOMIC GROWTH

My focus in this study has been on a fraction: government spending overall, and in various categories, as a percentage of GDP. That reminds us that a fraction can fall either because the numerator falls or the denominator increases.

So far I have not focused on the denominator, that is, GDP. I do so now. The period from 1990 to 2000, even though it included a small recession that began in 1990, was one of substantial growth. Between 1990 and 2000, real GDP grew from $6.708 trillion to $9.191 trillion.[13] That amounts to an annual average growth rate of 3.2 percent. That is a quite healthy growth rate for an economy that is not catching up to the rest of the world.

But it is not spectacular growth. To put that growth rate in perspective, the average growth rate of real GDP between 1959 and 1990 was actually higher, at 3.5 percent. The growth rate between 1980 and 1990 was also 3.2 percent. And even the growth rate from 1970 to 1980, not generally thought of as a high-growth decade, was the same 3.2 percent achieved in the 1990s.

Of course, this comparison of decades ignores the fact of recessions. Both the 1970s and the 1980s had severe recessions. In the 1970s, there was

12. Robert D. Reischauer, "The Budget: Crucible for the Policy Agenda," in *Setting National Priorities: Budget Choices for the Next Century*, ed. Robert D. Reischauer (Washington: Brookings Institution Press, 1997), 17.

13. Chairman of the Council of Economic Advisers, *Economic Report of the President* (2003), (Washington, DC: Government Printing Office, February 2003), 278, Table B-2, http://www.gpo.gov/fdsys/pkg/ERP-2003/content-detail.html. Throughout this study, I use GDP data that were computed before the Department of Commerce changed the method of computation. In my view, this is preferable because the traditional method accords better with the original goal of computing GDP: to measure production of final goods and services. The newer method counts R&D, which is not a final good or service, in GDP.

a recession between November 1973 and March 1975.[14] In May 1975, shortly after the recession ended and the recovery began,[15] the unemployment rate hit 9.0 percent.[16] In the early 1980s, there were two recessions, a mild one lasting from January 1980 to July 1980, and a severe one that lasted from July 1981 to November 1982. In July 1980, the last month of the 1980 recession, the unemployment rate reached 7.8 percent. In November 1982, the last year of the 1981–82 recession, the unemployment rate hit a peak of 10.8 percent. In the 1990s, by contrast, there was only a mild recession, from July 1990 to March 1991. That recession was unusual because the unemployment rate peaked in June 1992, more than a year after the recession ended.

To the extent that we use the fact of recessions to adjust our comparisons of growth rates in various decades, the adjustment only strengthens my point. The 1990s, with only a mild recession, did not outperform the 1970s or 1980s, each of which had at least one severe recession.

Why, then, do so many of us think of the 1990s as a period of unusually high growth? One possibility is that people put too much weight on the bad recessions in each of the prior decades. Another possibility, though, is that, at an intuitive level, we make an adjustment to GDP data that some economists, including me, have advocated:[17] do not equate the value of one dollar of government spending on goods and services to the value of one dollar spent on private consumption or investment. The GDP data treat these dollars the same way, but politicians and bureaucrats often spend money in wasteful ways because they are spending other people's money. Based simply on the economics of incentives, there is a presumption that a dollar of government spending on goods and services is worth less than a dollar of private spending on consumption or investment.

This is particularly relevant for the 1990s when, as noted above, most of the reduction in government spending as a percentage of GDP was in government spending on defense. Virtually all of that cut in defense spending was in spending on goods and services. It makes sense that people would feel better

14. The recessions are dated by a private organization, the National Bureau of Economic Research. See Christina D. Romer, "Business Cycles," in *The Concise Encyclopedia of Economics*, ed. David R. Henderson (Indianapolis: Liberty Fund, 2008), 47–51.

15. Unemployment rates during recessions tend to reach their maximum at the end of the recession or in the first few months of economic recovery from the recession.

16. The data on unemployment rates are from US Department of Labor, "Labor Force Statistics from the Current Population Survey," accessed May 23, 2015, http://data.bls.gov/timeseries/LNS14000000.

17. See David R. Henderson, "GDP Fetishism," *Econlib, Library of Economics and Liberty*, March 1, 2010, http://www.econlib.org/library/Columns/y2010/HendersonGDP.html.

off, especially after the end of the Cold War, if they spent an extra $10 billion on nice TV sets, cars, and other consumer items when the federal government would have otherwise spent the $10 billion on tanks, trucks, fighter planes, and ships for the military.

One striking fact is that the budget cuts throughout the 1990s did not appear to reduce growth. We often hear skeptics of budget cuts claim that they are dangerous during periods of low economic growth. And certainly the early 1990s were a time of low economic growth. But the cuts began in the early 1990s and continued throughout the decade. While growth throughout the 1990s was not stellar, growth in the last half of the 1990s, while the cuts were ongoing, was quite high, averaging 4.0 percent between 1995 and 2000.[18]

One striking fact is that the budget cuts throughout the 1990s did not appear to reduce growth.

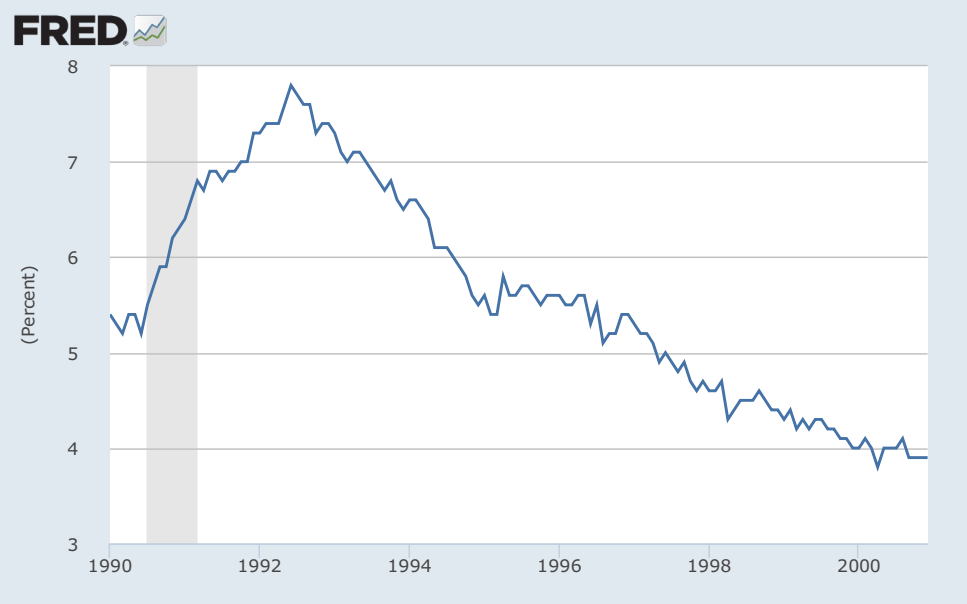
UNEMPLOYMENT

One worry that many people have about cuts in government spending is that they will cause an increase in the unemployment rate. The worry is that this increase will take place owing to either a deficiency of aggregate demand or a structural readjustment of the economy in response to shifts in demands in various sectors. Economist Arnold Kling calls this adjustment a "recalculation."[19]

The evidence from the 1990s shows not that these worries are unfounded, but that they are not as serious as many people have thought. As figure 7 shows, the 1990s unemployment rate peaked in June 1992, when it hit 7.8 percent, and averaged 7.5 percent for all of 1992. For the whole rest of the decade the unemployment rate steadily declined, hitting 4.2 percent in 1999 and 4.0 percent in 2000. Of course, much of this decline in unemployment in the late 1990s was owing to the high growth rate of GDP

18. Chairman of the Council of Economic Advisers, *Economic Report of the President* (2003), 278, Table B-2.
19. Arnold Kling, "The Recalculation Story: A Summary," *Econlog, Library of Economics and Liberty*, July 24, 2010, http://econlog.econlib.org/archives/2010/07/the_recalculati_2.html.

FIGURE 7. CIVILIAN UNEMPLOYMENT RATE FROM 1990 TO 2000



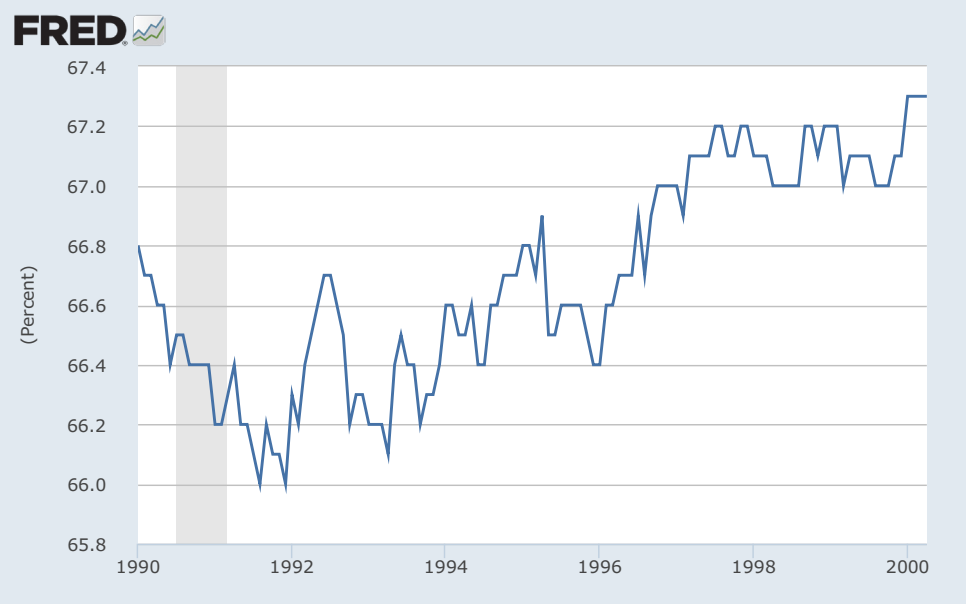
Note: Shaded area indicates US recession. Sources: St. Louis Federal Reserve, "Civilian Labor Force Participation Rate," accessed May 2014, https://research.stlouisfed.org/fred2/series/UNRATE; Department of Labor: Bureau of Labor Statistics.

in the last half of the 1990s. But what is striking is that even between 1992 and 1995, when the growth rate was not high and the defense budget was falling, the unemployment rate fell from 7.5 percent in 1992 to 5.6 percent in 1995.[20]

Of course, one cause of a lower unemployment rate can be, as we've seen in the recent recession and slow recovery, a decline in the labor force participation rate. But that was not a big factor in the decline in the unemployment rate during the 1990s. The figure below shows that while the early 1990s civilian labor force participation rate did peak at 66.7 percent in July 1992, it fell only slightly after that, reaching a 1992–2000 trough of 66.1 percent in April 1993. By October 1994, it was back to its July 1992 level of 66.7 percent and, after that, never fell below 66.4 percent for the rest of the 1990s.

20. St. Louis Federal Reserve, "Civilian Labor Force Participation Rate"; Department of Labor: Bureau of Labor Statistics.

FIGURE 8. CIVILIAN LABOR FORCE PARTICIPATION RATE FROM 1990 TO 2000



Note: Shaded area indicates US recession. Sources: St. Louis Federal Reserve, "Civilian Labor Force Participation Rate," accessed May 2014, https://research.stlouisfed.org/fred2/graph/?g=1gb8; Department of Labor: Bureau of Labor Statistics.

WHERE TO CUT?

It's clear that most of the 1990s cuts in government spending as a percentage of GDP were in the defense budget. As noted above, defense spending fell from 5.2 percent of GDP in FY 1990 to 3.0 percent in 2000. While defense spending has risen since then, in FY 2013 it was 3.8 percent of GDP. That means that it has less room to fall than it had in 1990. One could certainly imagine keeping America safe from foreign attack with a defense budget that was 1 or 2 percentage points smaller. Even cutting to 2.0 percent of GDP would give the United States a defense budget as a percentage of GDP that is greater than that of most of its main NATO allies, even though many of these allies, since they are in Europe, face more of a threat of an invasion than the United States does. The German government, for example, spends 1.3 percent of GDP on defense, Lithuania's government spends only 0.8 percent, Latvia's spends 0.9 percent, and almost all the European members of NATO spend under 2 percent of GDP on defense. This low spending reflects one or both of two possibilities: (1) that people in those countries do not think they are very threatened or (2) that they think the US government will come through and defend them. But most of

these countries are prosperous and the US government should leave them to estimate the threats for themselves and to defend themselves.[21]

A serious attempt to cut the federal spending budget would need to include not just defense spending but also spending on domestic programs. The three largest "entitlement programs," as noted earlier, are Social Security, Medicare, and Medicaid. All have proved difficult to cut, but all must be reformed to avoid huge problems in the next few decades. The reforms are imperative now that the first of the baby boomers are retiring. That generation will put immense pressure on these programs. Moreover, the large increases in spending anticipated under the Affordable Care Act threaten to add a fourth major "entitlement" to the mix. All should be restrained so that their percentage of GDP in the future will be less than currently estimated.

One of the most spectacularly failed attempts to cut the growth of Social Security spending was the Reagan administration's attempt, in its first few months, to cut the early retirement benefit in Social Security from 80 percent to 55 percent of the full benefit given to 65-year-olds. The attempt would have given those on the edge of retiring only a short time to adjust. Not surprisingly, there was huge outrage and the Reagan administration quickly withdrew its proposal.

The lesson from this episode is not that the growth of Social Security spending cannot be cut. Indeed, as former Reagan administration budget director David Stockman points out in his book *The Triumph of Politics*, he managed to help kill a Democratic congressman's proposal to raise the age at which full Social Security benefits could be received. Stockman writes:

> The only structural change the Pickle bill proposed was raising the normal retirement age from sixty-five to sixty-eight; but not until 1990, and even then it would be phased in so gradually that the change would not become fully effective until the year 2000.[22]

The Pickle whom Stockman refers to was Jake Pickle, a Democratic member of the House of Representatives from Texas and a protégé of the late Lyndon Johnson.

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21. Of course, following my proposal would involve, in the extreme, leaving NATO, but NATO came along when many European countries couldn't easily afford to defend themselves. That situation has changed dramatically, but, like most government bureaucracies, NATO has survived.
22. David A. Stockman, *The Triumph of Politics: How the Reagan Revolution Failed* (New York: Harper & Row, 1986), 183.

Would the Pickle bill have passed? Here's what Stockman writes:

> The problem was that by April 1981, the helpful but extremely limited step of raising the retirement age had become everyone's favorite Social Security reform fetish. This was true even among conservative politicians who had the guts actually to face the issue, such as Barber Conable, Bill Archer, and Bill Armstrong. All three were on the key congressional committees.[23]

Barber Conable was the well-respected ranking minority member of the House Committe on Ways and Means, and Bill Archer was one of the most respected members of the committee. Bill Armstrong was an up-and-coming Republican member of the Senate Committee on the Budget.

Note Stockman's use of the word "even" in front of their names. In other words, the bipartisan view was that the age needed to be raised. With "even" conservatives supporting it, it probably would have been.

And consider where we would be now if Pickle's proposal *had* passed. We would now be 15 years past the point where the full-benefit age for Social Security is 68, rather than 11 years before the point at which it becomes 67.

The lesson here is that proposed changes in Social Security benefits that bite in the short run are likely to fail and that prospective changes that would kick in gradually and give people many years to adjust in advance would have a much higher chance of succeeding. Of course, this would apply to changes in Medicare and Medicaid also.

Although this study is focused on the 1990s and not on specific changes in various programs that could be implemented to rein in spending, some broad outlines of approaches are worthwhile.

Consider, for example, Medicaid, a program whose expenses are shared by federal and state governments. The specific way they are shared gives state governments little incentive to reduce wasteful spending because a dollar saved in state Medicaid spending would benefit the state government by only about 40 cents. That suggests two possible ways to give state governments a stronger incentive to spend money more efficiently: turn the federal funding portion of Medicaid into a block grant program so that a dollar saved *by* the state government is a dollar saved *for* the state government, or change federal funding of Medicaid into a system of per capita payments. Under this latter plan, a dollar saved by the state government on a given Medicaid beneficiary

23. Ibid., 184.

would be a dollar saved for the state government, but increases in the number of a state's beneficiaries would increase federal spending on that state's Medicaid program. James C. Capretta has laid out these ideas with more detail and discussion than is given here.[24]

One might think that such changes would result in reduction of care for many Medicaid beneficiaries who need it. But, as Capretta points out, skeptics of welfare reform in the mid-1990s expressed similar worries and those worries turned out to be unfounded. Capretta writes:

> What happened instead is that the states reviewed who was on the cash assistance program and quickly found that many of them were capable of entering the workforce and improving their household incomes from wages instead of government assistance. By 2000, the cash welfare rolls had fallen by about half even as the population in the bottom fifth of the income distribution experienced substantial gains in their real incomes. Health coverage is more complicated than cash welfare, but there is every reason to expect that substantial inefficiency exists in Medicaid, and that a block grant would provide the incentive to find and eliminate it.

CONCLUSION

The fall of the Soviet Union created a one-time opportunity, which bipartisan leaders of Congress and a Republican and Democratic president jumped on, to reduce defense spending as a percentage of GDP. That peace dividend was the main source of the large 1990s cut in government spending as a percentage of GDP. Given that the US defense budget is the highest in the world and higher than the combined defense budgets of all the US government's potential adversaries, there is still room to cut defense spending substantially. But the growth in government spending in the future will be mainly in four programs: Medicare, Medicaid, Social Security, and the Affordable Care Act. If we wish to avoid having federal spending rise to well above its traditional 20 percent of

24. James C. Capretta, "Reforming Medicaid," in *The Economics of Medicaid: Assessing the Costs and Consequences*, ed. Jason J. Fitchner (Arlington, VA: Mercatus Center at George Mason University, 2014), 139–141. One fact relevant to choosing between block grants and per capita spending caps is that in the mid-1990s, when Congress was looking for ways to limit spending on Medicaid, per capita spending caps received strong bipartisan support. As Capretta, points out, in a December 1995 letter 46 Senate Democrats expressed their support for the Clinton administration's proposal for per capita spending caps for Medicaid.

GDP, therefore, reforms must be made to lower the growth of spending in these four categories.

What about interest on the debt? Interest rates are so low that they cannot fall much below their current level. So the only way to cut interest on the debt is to cut the debt. Moreover, if interest rates rise, which seems likely sometime in the future, net interest on the debt would also rise. Even a 1-percentage-point rise in interest rates on the approximately $12 billion in debt held by the public would increase government spending by a hefty $120 billion. This is about 0.75 percent of GDP. I suggested in an earlier study for the Mercatus Center that the government ought to refinance short-term debt that comes due by substituting long-term debt.[25] That way, when interest rates rise, the effect on interest on the debt is not so large. It should be noted, though, that this is a way of moderating future increases in government spending on interest rather than a way of reducing it. In fact, the refinancing of debt that I propose would immediately increase spending on interest because long-term rates on 30-year Treasury bonds, as I write this in late May 2015, are about 2 percentage points above rates on 3-year bonds.

A divided government, with a president of one party and a Congress of the other, might be expected to have more trouble cutting spending than a parliamentary government. But the US experience of the 1990s, when there was divided government for 8 of the 10 years, shows that government spending as a percentage of GDP was cut substantially. The main spending cuts were in defense, primarily because of the end of the Cold War, and these cuts reflected a broad consensus in thought among Republicans and Democrats. The lesson is that even with divided government, if there is broad consensus in favor of a spending cut, the spending cut has a good chance of happening.

Even with divided government and no consensus about the desirability of domestic spending cuts, domestic spending fell as a percentage of GDP at a time when, owing to demographics and expansions in Medicaid eligibility, that percentage was widely expected to grow.

Nor was this decline in government spending as a percentage of GDP attributable mainly to unusual growth in the 1990s. Contrary to what is widely believed, growth of GDP between 1990 and 2000, when there was only one relatively minor recession, was the same compounded rate of 3.2 percent annually that was achieved between 1970 and 1980 and between 1980 and 1990.

The economic and budget lesson seems clear: even mild restraint and some cuts in government spending, while the economy grows, can substantially reduce the budget deficit as a percentage of GDP. The political lesson is equally clear: these kinds of cuts can happen even with divided government.

25. See: Henderson, "Canada's Budget Triumph," 20–21.

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ACKNOWLEDGMENTS

I thank three anonymous reviewers and reviewer Patrick Knudsen for helpful comments as well as a receptive Capitol Hill audience of legislative aides who saw an earlier presentation. Some of them gave helpful comments as well. I also thank Jacob McLeod, an economics student at Florida State University and a research assistant at the DeVoe L. Moore Center, for his responsive research assistance.

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