Statement of
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before the
Committee on the Budget
United States House of Representatives

February 20, 1985

NOTICE

This document is not available for public release until it is delivered at 9:00 a.m. (EST) on Wednesday, February 20, 1985.

Mr. Chairman, I am honored to be among the first to testify as you take on your new, challenging role. The Congressional Budget Office (CBO) is releasing at this time the second part of its annual report, Reducing the Deficit: Spending and Revenue Options. My testimony today will briefly review our latest forecast and budget projections and then turn to a menu of options for reducing the budget deficits.

CBO'S FORECAST AND PROJECTIONS

Real GNP grew at a rapid 5.6 percent rate between the last quarters of 1983 and 1984, the unemployment rate declined to 7.2 percent by the fourth quarter of the year, and the inflation rate averaged about 4 percent during 1984. Conditions now appear to be set for continued economic expansion with little increase in inflationary pressure.

The Short-Run Economic Forecast

CBO's economic forecast for the next two years incorporates the following assumptions: unchanged federal budget policies; growth in the money supply (M1) of 5.5 percent from the end of 1984 to the end of 1985—the midpoint of the tentative target range announced by the Federal Reserve last July—and 5.0 percent in 1986; a lower price of imported oil; and an average value of the dollar in international exchange markets this calendar year that will be about the same as last year.

Based on these assumptions, CBO now forecasts real growth will be about 3½ percent over the four quarters of 1985 and slightly less during

1986. It projects inflation will remain low in 1985 (slightly over 3.5 percent) and will rise somewhat in 1986, while unemployment rates fall slowly throughout the period.

The Medium-Term Projections

In its medium-term projections, CBO assumes that from the fourth quarter of 1982 (the recession trough) to the fourth quarter of 1990 the growth of GNP and of labor productivity will equal the average growth rate following earlier postwar recessions, yielding average real GNP growth of about 3.4 percent a year in the 1987-1990 period. Productivity growth in the nonfarm business sector would average about 2.2 percent (see Table 1).

Uncertainties in the Economic Outlook

The economy's performance could easily turn out to be much better or worse than CBO's projections indicate. At present, the major uncertainties in the short run are related to inventories, oil prices, and interest rates. Some analysts fear that a temporary reduction in output growth will be necessary this year to reduce inventories. Others expect that oil prices will decline more sharply than projected by CBO, a development that could have beneficial effects on both inflation and real growth. A more fundamental risk arises from the fact that our healthy, noninflationary recovery and the accompanying high rate of capital formation have been facilitated by large inflows of international capital. 1/ If that inflow were to evaporate abruptly,

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1. Much of this international capital is American owned, but would have otherwise been invested abroad.

TABLE 1. MEDIUM-TERM ECONOMIC PROJECTIONS FOR CALENDAR YEARS 1987-1990

	Actual	Forecast					
	1984	1985	1986	1987	1988	1989	1990
GNP (billions of current dollars)	3,661	3,927	4,238	4,567	4,921	5,301	5,711
Nominal GNP Growth Rate (percent change, year over year)	10.8	7.3	7.9	7.8	7.7	7.7	7.7
Real GNP (percent change, year over year)	6.8	3.5	3.2	3.3	3.4	3.4	3.4
GNP Implicit Price Deflator (percent change, year over year)	3.7	3.6	4.6	4.4	4.2	4.2	4.2
CPI-U (percent change, year over year)	4.2	3.7	4.5	4.2	4.2	4.2	4.2
Civilian Unemployment Rate (percent, annual average)	7.5	7.1	6.9	6.7	6.6	6.4	6.2
Three-Month Treasury Bill Rate (percent, annual average)	9.5	8.3	8.7	8.2	8.2	8.2	8.2

SOURCE: Congressional Budget Office.

American inflation and interest rates would rise as the dollar's value fell, thus placing the recovery in jeopardy. Consequently, CBO's relatively optimistic outlook depends to a large degree on the assumption that the capital inflow will continue. Other risks relate to the financial stress being experienced in agriculture and other sectors. CBO assumes that these problems will be confined to the sectors directly affected and will not spread in any significant way to the rest of the economy.

Although the baseline projection for the out-years does not explicitly incorporate a recession or an inflationary shock of any kind, such events could occur. Because the timing of such events is impossible to forecast so far in advance, however, our projections simply smooth out real growth and inflation rates over the period.

The Budget Outlook

Given baseline economic assumptions and no change in the budget policies now in place, CBO estimates that the total federal deficit—including off-budget spending—will rise from $214 billion in 1985 to nearly $300 billion by 1990 (see Table 2). Except for the current fiscal year, the projected total deficits for the 1986-1989 period are very close to those calculated in our August report. The 1985 total deficit estimate, however, has been raised by $23 billion—from $191 billion to $214 billion—largely because of lower anticipated revenues and a one-time increase of $13 billion in spending for purchases of federally guaranteed notes issued by local public housing authorities.

TABLE 2. BASELINE BUDGET PROJECTIONS (By fiscal year)

	1984 Actual	1985 Base	Projections 1986	1987	1988	1989	1990
			In Billions of Dollars				
Baseline with Budget Resolution Defense Authority a/							
Revenues	666	735	788	855	934	1,005	1,088
Total Outlays b/	852	949	1,003	1,088	1,183	1,276	1,384
Total Deficit b/	185	214	215	233	249	272	296
Debt Held by the Public	1,313	1,526	1,740	1,972	2,220	2,490	2,786
Baseline with No Real Growth in Defense c/							
Revenues	666	735	788	855	934	1,005	1,088
Total Outlays b/	852	949	997	1,068	1,142	1,210	1,286
Total Deficit b/	185	214	208	213	207	205	198
Debt Held by the Public	1,313	1,526	1,733	1,945	2,151	2,356	2,552
			As a Percent of GNP				
Baseline with Budget Resolution for Defense a/							
Revenues	18.6	19.1	19.0	19.1	19.3	19.3	19.4
Total Outlays b/	23.8	24.6	24.1	24.3	24.5	24.5	24.7
Total Deficit b/	5.2	5.6	5.2	5.2	5.1	5.2	5.3
Debt Held by the Public	36.7	39.6	41.8	44.0	46.0	47.9	49.7
Baseline with No Real Growth in Defense c/							
Revenues	18.6	19.1	19.0	19.1	19.3	19.3	19.4
Total Outlays b/	23.8	24.6	24.0	23.8	23.6	23.2	22.9
Total Deficit b/	5.2	5.6	5.0	4.7	4.3	3.9	3.5
Debt Held by the Public	36.7	39.6	41.7	43.4	44.5	45.3	45.5
Reference: GNP (in billions of dollars)	3,581	3,855	4,158	4,483	4,830	5,204	5,606

SOURCE: Congressional Budget Office.

a. Defense budget authority for 1986 and 1987 is assumed to be the amounts specified in the most recent Congressional budget resolution. Defense budget authority for 1988-1990 is an extrapolation of the budget resolution prepared for the staffs of the House and Senate Budget Committees. Outlays are estimated consistently with the assumed budget authority using CBO technical estimating methods.

b. Includes off-budget spending, primarily by the Federal Financing Bank.

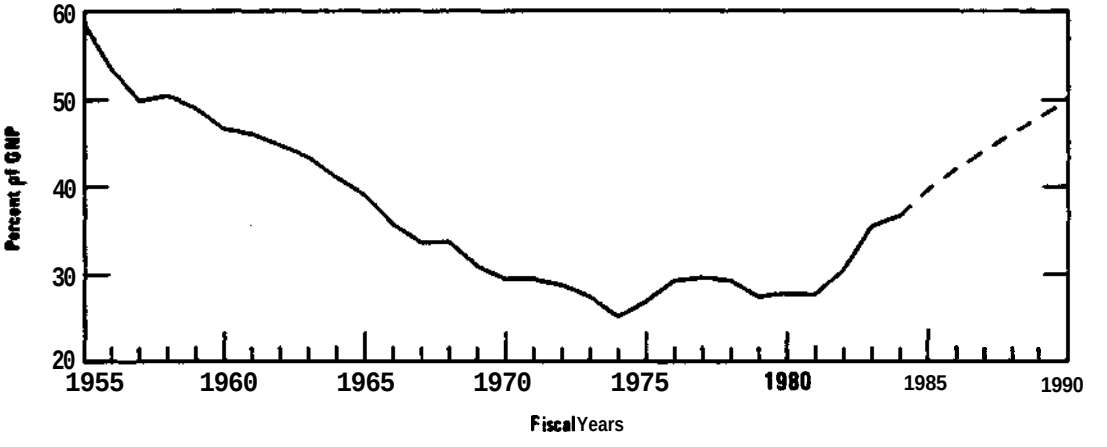
c. Defense budget authority for 1986 through 1990 is the amount that would provide no real growth under CBO economic assumptions.

Under current laws and budget policies, projected total deficits are stabilized at around 5.2 percent of GNP through 1990--in contrast to our projections of a year ago, when the deficit was rising as a percentage of GNP. This improvement results from policy changes in the Deficit Reduction Act and other measures.

With current policies, these deficit projections imply that federal debt held by the public would grow from $1.3 trillion at the end of fiscal year 1984 to $2.8 trillion by the end of 1990, an accumulation that outpaces the growth in the economy by a wide margin. The debt held by the public would grow from under 30 percent of GNP during the 1970s to nearly 50 percent by 1990 (see Figure 1).

I would like to emphasize that our projections are not meant to be forecasts of future budget outcomes, but merely what would happen to the budget if current laws and policies were continued unchanged. In that sense, they provide a useful benchmark or baseline against which proposed policy changes can be measured. In preparing our baseline projections, it is necessary to adopt a number of conventions or assumptions as to what constitutes current budgetary policies. In some cases, the choice of assumptions can have a substantial effect on the projections. For example, for defense spending we use an extrapolation of the most recent Congressional budget resolution as the best approximation of current policy. An alternative approach would be to assume no real growth in defense budget authority, essentially the same assumption that is used for nondefense discretionary spending programs. The effect of this alternative assumption

FIGURE 1. FEDERAL DEBT HELD BY THE PUBLIC



SOURCE: Congressional Budget Office.

is to hold the budget deficit at about the present level for the next several years. As shown in Table 2, under a zero-real growth assumption for defense spending, the baseline deficit in 1990 is projected at $198 billion. This amount is almost $100 billion lower than the deficit projected under an extrapolation of defense spending implied by last year's budget resolution.

Finally, in terms of the budgetary outlook, I must underscore the sensitivity of the specific numbers to the actual state of the economy. If the economy performs better than projected, deficits will be less than projected. But the opposite also holds: a weaker economy implies a bleaker budgetary picture.

We have provided two alternative sets of economic assumptions that are very likely to bracket the range of possibilities. (See The Economic and Budget Outlook; Fiscal Years 1986-1990. pp. 69-73.) In one set, the economy duplicates the extraordinary growth performance of the 1960s. Even in this scenario, under current policy, the budget remains far from balanced. The implied 1990 deficit is $126 billion or 1.9 percent of the GNP--a ratio exceeded only once in the 1960s. In the other set of economic assumptions, we assume a severe recession in 1987 and as a result the 1990 deficit soars to $425 billion or 8.7 percent of a much lower GNP.

RAMIFICATIONS OF DEFICITS

Part I of our annual report, The Economic and Budget Outlook; Fiscal Years 1986-1990, describes what is known about the consequences of deficits. While we expect the economy to continue to do well in the next few years in the face of large deficits, there are two highly detrimental aspects of continued high deficits that I would like to highlight here: the growing importance of interest payments on the debt and the erosion of our future potential for economic growth.

Outlays for Interest on the Debt

Under current budget policies, the outstanding federal debt would rise dramatically, implying that federal spending for interest payments would also rise sharply. The direct consequence of this rise would be to limit

federal resources available for other spending programs. Just how fast interest payments will rise would depend on the rate of growth of the outstanding debt and the level of interest rates. In CBO's baseline, net interest costs are the fastest growing category of spending, rising from $111 billion in fiscal year 1984 to $230 billion in fiscal year 1990.

As interest costs mount, increasingly stringent budgetary actions are needed just to stand still. Moreover, if it became politically unfeasible to offset growing interest costs by raising taxes or cutting programs, there would be a strong temptation to finance government by creating money rather than by further borrowing. The result would, of course, be highly inflationary.

Long-Run Effects of Deficits

There is little disagreement about the adverse effect of persistent large deficits on future generations. If deficits are financed entirely through domestic savings, rising federal debt would supplant more and more private debt and equity in the portfolios of private investors. Slower growth of private capital stock would then result in lower productivity than would occur with smaller deficits, thereby lowering the income of future generations. Alternatively, if the deficits were partly financed by inflows from international capital markets, as is happening today, the net foreign asset position of the United States would continue to deteriorate. While investment can be maintained at higher levels than would be possible

without such inflows, U.S. residents would enjoy a shrinking proportion of the production generated because of rising net interest and dividend payments abroad. Either way, the welfare of future generations is eroded.

GOALS FOR DEFICIT POLICY

If policies must be changed, what is an appropriate goal for deficit reduction?

The traditional goal of a balanced budget seems beyond reach during the three-year period covered by the budget resolution. The goal of balancing the high-employment budget is only slightly less difficult. A potentially appealing intermediate goal might be found by considering the role of interest payments in the budget problem. If the debt-to-GNP ratio, which drives the size of interest payments relative to GNP, could be stabilized and then eventually reduced, the interest burden would begin to shrink relative to other spending and to tax receipts. A major part of the budget problem--interest payments--would thus be converted into a large part of the solution, and the budget dilemma would appear to be much more tractable. For this reason, the Economic Report of the President's Council of Economic Advisers this year calls stabilization of the debt-to-GNP ratio "the first priority of near-term fiscal policy."

One budget goal that has been widely discussed this year is to lower the budget deficits to 4.0 percent of GNP in 1986, 3.0 percent in 1987, and 2.0 percent in 1988. This goal also has the attribute of stabilizing the debt-

to-GNP ratio by 1987. The required program changes (spending reductions or tax increases or both) would be quite large--$47 billion in 1986, $89 billion in 1987, and $130 billion in 1988 (see Table 3, Path 1). Total interest savings would amount to $34 billion over the three-year period. Moreover, if market interest rates responded favorably to these policy changes, the added interest savings would bring about a debt-to-GNP ratio that was already declining in 1987. 2/

If policy changes of this magnitude cannot be achieved this year, the goal of stabilizing the debt-to-GNP ratio might be delayed until 1988, the last year of the next budget resolution's three-year planning horizon. Reaching this goal would still require considerable policy changes this year. One possible path involves program cuts or tax increases of $30 billion in 1986, $55 billion in 1987, and $90 billion in 1988--approximately the same time profile of policy changes manifested by the down payment on the deficit in 1984 (see Table 3, Path 2). These program changes would produce interest savings of $22 billion over the next three years.

If nothing is done in 1986, but the same plan is implemented in 1987, the debt-to-GNP ratio will continue rising through 1988 (see Table 3, Path 3) and the program changes needed will be greater to eventually achieve the previous path's debt-to-GNP ratio by a particular date. Even by 1988, interest outlays would be $8 billion higher under the third budget reduction

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2. Most deficit reduction programs would cause the debt-to-GNP ratio to fall in years past the point where stability is achieved if the policy changes are of an enduring nature.

TABLE 3. THREE PATHS TO DEFICIT REDUCTION

	1986	1987	1988
	In Billions of Dollars		
Baseline Deficit a/	215	233	249
Policy Savings from Baseline			
Path 1	-47	-89	-130
Path 2	-30	-55	-90
Path 3		-30	-55
Interest Savings			
Path 1	-2	-10	-22
Path 2	-2	-6	-14
Path 3	--	-2	-6
Total Deficit			
Path 1	166	134	97
Path 2	183	172	145
Path 3	215	202	188
	In Percents		
Deficit/GNP			
Baseline	5.2	5.2	5.1
Path 1	4.0	3.0	2.0
Path 2	4.4	3.8	3.0
Path 3	5.2	4.5	3.9
Debt/GNP			
Baseline	41.8	44.0	46.0
Path 1	40.7	40.7	39.7
Path 2	41.1	41.9	41.9
Path 3	41.8	43.3	44.0

SOURCE: Congressional Budget Office.

a. Includes off-budget spending.

plan than under the second, and $16 billion higher than under the first plan. These large interest costs can be thought of as larger policy changes that will be required to offset delays in action. $16 billion in 1988 is enough to fund all federal spending (on- and off-budget) on the science, space and technology and energy functions under current policies.

These paths involve very substantial program reductions or tax increases. If we focus on 1988, the target deficits range from $97 billion to $188 billion, or program reductions from the CBO baseline of $55 billion to $130 billion. 3/

There is no particular deficit reduction path that is clearly superior to all others. The choice of a strategy is a value judgment as much as it is one based on economic considerations. The key question is what sort of legacy do we wish to leave? Should it involve imposing large debt-service burdens on future generations? Or should we now bear the sacrifice of program cuts or tax increases in order to enhance the living standards of our children and theirchildren?

It is important to stress that every extra bit of deficit reduction has an important quantitative impact on the long-run budget outlook because of its indirect effect on the interest cost of the debt. Given CBO's interest-

3. The debate is frequently confused by calculating savings against alternative deficit projections (such as the Administration's current services budget or previous estimates from a variety of sources). Depending on the base, a given pattern of deficits is equivalent to many alternative calculations of "savings." Throughout this discussion, we consider only the CBO baseline.

rate assumptions, a one-dollar program cut or tax increase, lasting for the 1985-1990 period, results in an interest saving of over 70 cents in 1990. Consequently, it is important not to give up because a particular deficit target cannot be achieved or to shy away from exceeding a target if the opportunity arises.

COMPOSITION OF SPENDING

The most important characteristic of federal spending is that it is dominated by very few programs. Table 4 shows that by 1988 national defense, health care, retirement and disability, and net interest alone account for over 80 percent of baseline budget outlays. Thus, deficit-reduction plans that concentrate solely on spending reduction either must make significant inroads in spending in these few categories or they must make even more radical moves--such as terminating significant programs--in the remainder of the budget. While CBO has not completed its analysis of the President's budget, that proposal places heavy emphasis on terminating programs, and on some significant reductions in health programs as well.

BROAD ISSUES IN DEFICIT REDUCTION

One clear lesson of the analyses done over the past several years is that the deficit problem is chronic. As a result, satisfactory solutions must involve fundamental, as opposed to temporary, policy changes. Policies that simply postpone expenditures are unlikely to impress financial markets even though they may significantly reduce deficits in the short run. Conversely,

TABLE 4. COMPOSITION OF CBO BASELINE FEDERAL SPENDING (In fiscal years 1985 and 1988)

Budget Category	Estimated 1985	Projected 1988	Growth from 1985 through 1988	
	In Billions of Dollars		In Billions of Dollars	In Percents
National Defense	252	347	95	38
Entitlements and Other Mandatory Spending	436	510	74	17
Health care	(92)	(123)	(31)	(34)
Retirement & disability	(253)	(307)	(54)	(21)
Other a/	(91)	(80)	(-11)	(-12)
Nondefense Discretionary	168	191	23	14
Net Interest	130	186	56	43
Offsetting Receipts	-48	-59	-11	23
Budget Outlays	938	1,174	236	25
Off-Budget Outlays	11	8	-3	-27
Total Outlays	949	1,384	233	25
Reference: GNP	3,855	4,830	975	25
	As a Percent of GNP		Percentage Point Change	
National Defense	6.5	7.2	0.7	
Entitlements and Other Mandatory Spending	11.3	10.6	-0.7	
Health care	(2.4)	(2.5)	(0.1)	
Retirement & disability	(6.6)	(6.3)	(-0.3)	
Other a/	(2.4)	(1.6)	(-0.8)	
Nondefense Discretionary	4.3	3.9	-0.4	
Net Interest	3.4	3.9	0.5	
Offsetting Receipts	-1.2	-1.2	0.0	
Budget Outlays	24.3	24.3	0.0	
Off-Budget Outlays	0.3	0.2	-0.1	
Total Outlays	24.6	24.5	-0.1	

a. The comparison of 1985 to 1988 in this line is distorted by a $13 billion one-time outlay in 1985 resulting from a change in the method of refinancing public housing. See CBO's The Economic and Budget Outlook: Fiscal Years 1986-1990 (February 1985), p. 134.

policy changes that promise long-run savings may have a big market impact even though those savings do not affect outlays immediately. Clearly, short-run efforts should be embedded within a long-run strategy of fiscal control.

For the remainder of this testimony, I will turn to some of the major options for reducing spending or raising revenues. It should be noted at the outset that there are no simple and obvious ways of painlessly reducing deficits. Virtually every proposal that would bring about significant savings hurts some people or institutions. Nevertheless, unless such choices are made, current fiscal policies will themselves inflict long-run injury on a wide scale.

National Defense

In 1985, outlays for national defense will total $252 billion or 27 percent of total spending; an extension of last year's budget resolution envisioned a 38 percent increase by 1988. This increase compares with the President's request for about a 41 percent increase over the same period. Although there is a broad national consensus that substantial resources must be devoted to national defense, arguments rage about how much is enough or, more specifically, about how much risk must be attached to various program reductions from the President's defense requests.

If it is decided to reduce the rate of growth of defense spending, it is appropriate to focus on choosing among different lower paths of budget authority rather than outlays because of the importance of multiyear

planning and contracting. Table 5 shows savings in budget authority under various rates of defense growth. For example, if the Congress elected to provide no real growth for defense for the next five years, savings in budget authority would equal $18.5 billion in 1986, $61 billion in 1988, and would total $318 billion in the 1986-1990 period.

While it is important continually to pursue management efficiency in the defense establishment, large and lasting reductions in defense spending are likely to require more fundamental changes in defense policy. Several types of changes are possible:

- Reducing rates of growth in major procurement—either by cancelling selected weapons programs of lower priority or by limiting rates of production--could result in substantial savings; the pace of modernization, however, would be slowed. Some of the 11 examples of this strategy cited in our report (with 1986 budget authority savings in parentheses) include: cancel the MX missile ($4.1 billion), slow F-15 aircraft production ($0.3 billion), cancel the Division Air Defense Gun ($0.6 billion), and reduce the number of new submarines and amphibious ships ($1 billion).
- Limiting increases in investment accounts other than those for major weapons would slow research and development and limit improvements in the ability to sustain combat in a protracted war. Again, however, potential savings are substantial. To cite one

TABLE 5. NATIONAL DEFENSE BUDGET AUTHORITY UNDER ALTERNATIVE SPENDING ASSUMPTIONS
(By fiscal year, in billions of dollars) a/

Spending Assumptions	1986	1987	1988	1989	1990	Cumulative Five-Year Total b/
Budget Authority Level						
Administration Proposal	322.2	363.3	411.5	448.9	488.1	2,034.0
CBO Baseline	324.7	359.8	397.8	439.4	485.4	2,007.1
3 Percent Real Growth, 1986-1990	315.5	340.2	368.0	398.0	430.4	1,852.1
Zero Real Growth in 1986, 3 Percent in 1987-1990	306.2	330.4	357.2	386.4	418.0	1,798.2
Zero Real Growth, 1986-1990	306.2	320.8	336.7	353.6	371.4	1,688.7
Budget Authority Savings from Administration Proposal						
3 Percent Real Growth, 1986-1990	6.7	23.0	43.5	50.9	57.7	181.8
Zero Real Growth in 1986, 3 Percent in 1987-1990	16.0	32.9	54.3	62.5	70.1	235.7
Zero Real Growth, 1986-1990	16.0	42.5	74.7	95.2	116.7	345.1
Budget Authority Savings from CBO Baseline						
3 Percent Real Growth, 1986-1990	9.2	19.6	29.8	41.4	55.0	155.0
Zero Real Growth in 1986, 3 Percent in 1987-1990	18.5	29.4	40.6	53.0	67.4	208.9
Zero Real Growth, 1986-1990	18.5	39.0	61.1	85.8	114.0	318.3

SOURCE: Congressional Budget Office.

a. The CBO baseline and alternative growth rate assumptions are all based on CBO baseline economic assumptions. Outlay savings associated with each of the spending assumptions depend on the composition of specific options chosen. Outlays associated with the Administration's defense budget will be reestimated using CBO economic assumptions in CBO's An Analysis of the President's Budgetary Proposals for Fiscal Year 1986, February 1985 (forthcoming).

b. Numbers may not add to totals because of rounding.

example, the Administration plans to spend $33 billion on research involving the Strategic Defense Initiative over the next five years; completing that research over six rather than five years would reduce 1986 budget authority by $0.9 billion.

- Limiting further improvement in readiness would preserve the gains already made in this important area—gains the services argue have led to high readiness in many cases—while holding down costs. For example, reducing growth in the operation and maintenance account by amounts similiar to reductions imposed by the Congress in the past would reduce 1986 budget authority by $2.5 billion.
- Limiting growth in pay and benefits by targeting increases only to areas of specific shortages would, according to some past studies, result in substantial savings while minimizing adverse effects on recruiting and retention. Modifying the military retirement system--by limiting COLAs to the CPI-minus-two provision--would reduce budget authority by $4.1 billion in the year it was enacted. Skipping the proposed military pay raise of 3 percent this July would save $1.9 billion in 1986.

The few examples mentioned here are certainly not exhaustive; nor is the larger number of options outlined in our report. The report's options are enough, however, to assemble packages that significantly reduce defense spending by slowing investment, force growth, or operating costs—or by some combination of these options. The choice affects the speed of

modernization versus improvements in numbers of forces and readiness. It also determines when the effects on deficits take place. Emphasis on slowing investment means smaller outlay reductions in the budget year. For example, providing no real growth in defense budget authority in 1986--which reduces 1986 budget authority by $18.5 billion--would reduce outlays by $4 billion in 1986 if proportional changes were made only in investment accounts. Alternatively, outlays would be cut by $10 billion in 1986 if changes were made proportionally in all defense accounts. Either strategy, however, would eventually save about $18 billion in outlays.

Entitlements

The entitlements component of the budget consists of programs that provide benefits automatically to all individuals, businesses, or state and local governments that qualify under authorizing statutes and apply for aid. This category constituted over 40 percent of total spending in 1985, but is projected to grow at a slightly lower rate than other spending during the rest of the decade. In order to reduce net outlays under such programs, it is necessary either to reduce the number of individuals or organizations that qualify for aid, lower the cost to the government for each recipient, or raise the taxes used to finance benefits. The examples I will cite here involve the largest entitlements--health-care and retirement and disability programs.

Health Care. Medicare and Medicaid--the two health-care entitlements--will cost the federal government $92 billion in 1985, with Medicare accounting for three-fourths of that amount. Since their creation two

decades ago, these programs have grown rapidly, fueled in large part by rises in the price of medical services and in the intensity of their use. While the drop in inflation and legislative changes made over the last few years have slowed the rate of increase in outlays, spending under these programs continues to grow more rapidly than either overall federal expenditures or the economy as a whole. Under CBO's current policy baseline, health-care outlays are projected to rise 65 percent by the end of the decade, growing from 10 percent to 11 percent of the federal budget and from 2.4 percent to 2.7 percent of GNP. The growth of spending under Medicare also threatens the solvency of that program's Hospital Insurance Trust Fund by some time in the 1990s.

One means of slowing projected spending growth would be to tighten the limits on reimbursement that were recently imposed under Medicare for both hospitals and physicians. For example, freezing hospital reimbursement rates for one year and constraining future increases would reduce outlays by $1.5 billion in 1986 and by $12.3 billion over the next five years, relative to CBO's baseline. Similarly, extending for one year the current 15-month freeze on physicians' fees would save about $0.5 billion in 1986 and $3.2 billion during the 1986-1990 period. While these options would not directly raise costs to program beneficiaries, they pose some risk of eventually reducing access to or the quality of care for Medicare patients. Also, savings could be less than expected if health-care providers responded by increasing the volume of services to beneficiaries.

A second approach for achieving savings would be to require that beneficiaries pay a larger share of their health-care costs. Increasing the premiums charged under Medicare's physicians' insurance program from the current 25 percent of program costs to 35 percent, for example, would reduce net federal outlays by more than $17 billion over the next five years, while raising each beneficiary's expenses by an average of about $7 per month in the first year. Another option would be to raise annual deductible amounts. This would lower Medicare outlays and might make beneficiaries more cost-conscious in their use of medical services, but would target the burden toward those already incurring high medical expenses.

Finally, additional revenues could be raised to fund these programs. For example, if the payroll tax used to finance Medicare's hospital insurance (HI) program were increased by one-half of one percentage point for both employers and employees, an additional $99 billion would be raised over the next five years. This approach would do much to improve the financial condition of the HI trust fund, but it would do nothing to alter the incentives faced by either the providers or the consumers of health care.

Retirement and Disability Programs. Retirement and disability programs will cost $253 billion in 1985, or more than one in every four dollars spent by the federal government. Social Security alone will account for $185 billion; federal civilian and military retirement and disability benefits will make up an additional $39 billion. Recent attention in this area has focused on options for restricting automatic cost-of-living adjustments (COLAs) that currently index benefits to price increases.

Numerous schemes could be devised to restrict COLAs, with differing effects on federal outlays and on program beneficiaries. For example, eliminating COLAs for one year in all non-means-tested programs would reduce federal outlays by $6.2 billion in 1986 and by about $9 billion in each of several years thereafter. While more than 90 percent of the benefit loss from such an action would fall on people with incomes greater than the official poverty line, approximately 3.3 million poor households would experience losses of benefits averaging between $10 and $15 per month. Most of the adverse effect on the poor could be eliminated by continuing to grant COLAs to beneficiaries whose Social Security payments are less than the poverty thresholds. This strategy, however, would reduce 1986 savings to $4.9 billion and annual out-year savings to about $7 billion. An alternative to any modification of the current indexing of benefits would be to lower the income thresholds for taxation of Social Security benefits. The intent of this approach would be to place the increased burden on those elderly recipients most able to pay.

Any COLA limitation would spread the burden over a large number of people but would only affect those now receiving benefits. If parallel changes were made in the formula used to set starting benefits, current and future beneficiaries would be treated more nearly the same, and long-term savings to the government could be very large.

Agricultural Price Supports

Agricultural price-support outlays cannot be reduced significantly without basic changes in current programs. These changes could be made in very different ways depending on Congressional objectives.

Income support, for example, could be approached through mandatory production controls on major crops, which would naturally result in higher prices. Thus, consumers would pay more of the costs of supporting farmers' incomes, while taxpayers would pay less. Effective production controls could reduce price-support outlays by about $20 billion over the 1987-1990 period. Crop farmers' incomes would be higher in the intermediate term but uncertain in the long-run since higher prices would also reduce crop exports. A reduction in farm output to boost farm incomes would also harm farm-related businesses such as fertilizer and farm equipment dealers.

Alternatively, targeted income support could be used to direct federal assistance to those farmers most in need. For example, the $50,000 payment limitation per individual could be reduced to $10,000, thus reducing outlays by about $4 billion over 1987-1990. Some form of means test, however, would be necessary to assure that the support reached those farmers most in need.

Finally, an objective of stabilizing farm prices and incomes would call for flexible price supports and the elimination or phasing out of deficiency payments. Budget savings over 1986-1990 would be about $29 billion from the immediate elimination of deficiency payments, starting with 1986 crops, and about $17 billion from a gradual elimination of payments by 1990. This

approach would reduce government support levels for a sector now experiencing serious financial distress and would hasten the movement of productive resources out of agriculture. But the impact would be mitigated in the long run as production and prices adjust, and as exports are stimulated by lower price-support levels.

Nondefense Discretionary Spending

For the last 20 years, nondefense discretionary spending--a catchall category in the budget for everything that is not national defense, entitlements, or interest--has taken up a remarkably narrow range in share of GNP. In 1965, these programs were slightly under 5 percent of GNP; they peaked at 5.5 percent of GNP in 1980, and now stand at 4.3 percent of GNP. Not all components of nondefense discretionary spending have declined equally over the past five years. A few programs have been severely reduced (for example, manpower programs, emergency energy preparedness, and pollution control). Some discretionary programs, like aid to education, have not been allowed to rise with inflation. Certain discretionary spending (such as international security assistance, health research, and veterans' medical care) has actually received substantial increases. As steps are taken to reduce the deficit, spending priorities will be continually reassessed. For this reason, the deficit reduction volume tries to set out broad-based strategies that can be applied to different parts of this diverse spending area:

- o Shifting responsibility to users of federally supported facilities. For example, options are presented for increasing user fees on inland waterways and for reducing subsidies for Northwest electric power and commercial energy and aeronautical research.
- o Shifting responsibility to state and local governments for mass transit, legal services, and certain education functions.
- o Narrowing aid for economic development and other programs.
- o Limiting federal credit subsidies, such as those under the rural housing program.

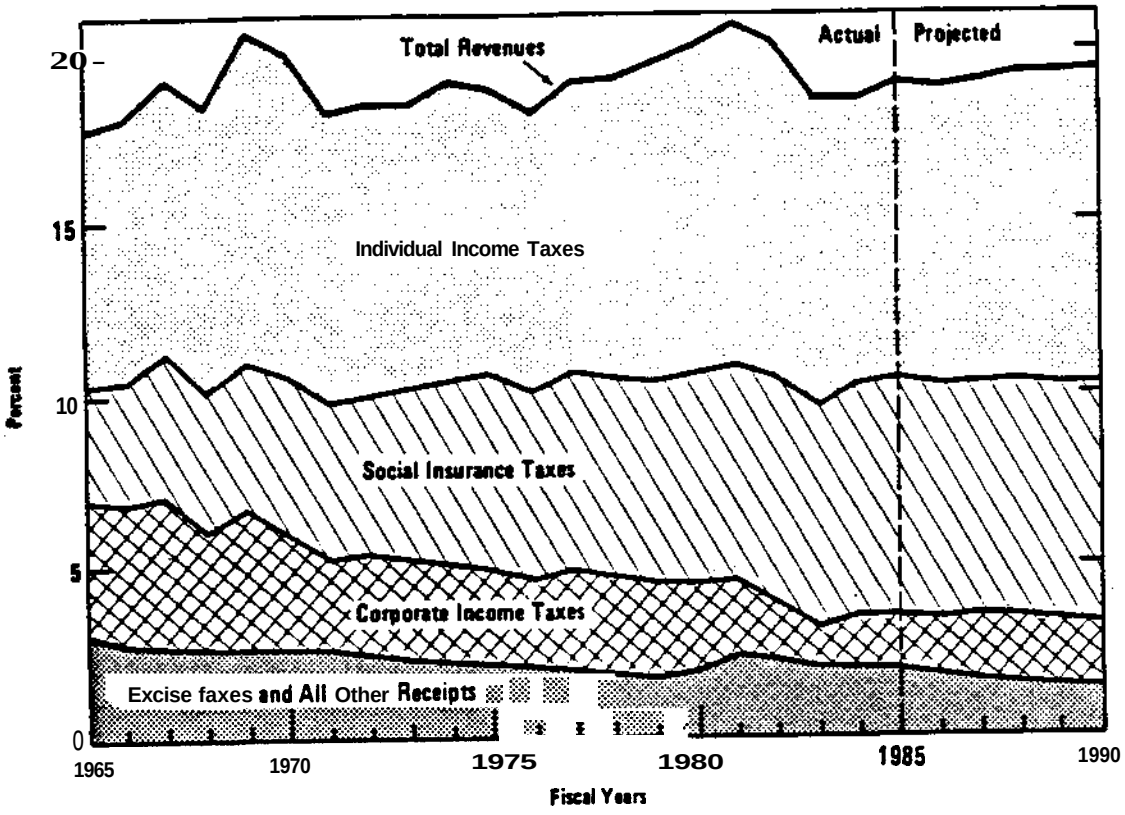
The CBO's list is highly selective; it is limited to major programs and constrained by the impossibility of an office of CBO's size to be expert in everything. But it should give the Congress an idea of the advantages and disadvantages of these separate strategies.

Revenues

Lack of significant reduction in the deficit via spending cuts must ultimately lead to consideration of increases in taxes. Postponing this reckoning means more debt, more interest and, eventually, even greater taxes.

Historical Perspective and Baseline Projections. Under laws now in place, federal revenues are projected to rise slightly from 19.1 percent of GNP to around 19.4 percent in 1990, which is about the average for the period since 1960 (see Figure 2). Since 1960, however, the contribution of

FIGURE 2. REVENUES BY SOURCE AS PERCENTS OF GNP



SOURCE: Congressional Budget Office.

different federal taxes to total revenues has shifted markedly. The individual income tax has continued to yield between 40 percent and 50 percent of total revenues, while the share of the corporate income tax has dropped from 23 percent to 8.5 percent (up from the shares in 1982 and 1983). The social insurance tax share has increased from 16 percent in 1960

to 36 percent. These trends are expected to change only slightly by 1990, with the share of the corporate income tax rising to about 10 percent.

There are three general methods of raising taxes: increase tax rates on existing tax bases, introduce new taxes (such as a general sales tax), or broaden the base of existing taxes.

Raising Tax Rates. Tax rate increases can be explicit, or can take other forms such as eliminating indexing of the individual income tax. Rate increases can raise large amounts of revenue quickly and simply. For example, a 10 percent surtax on the individual income tax would raise about $34 billion in 1990; repeal of indexing would raise about $58 billion in 1990; and a 10 percent surtax on corporate tax liabilities before credits would raise about $14 billion in 1990.

Advantages to increasing rates are administrative ease, mechanical simplicity, and the fact that revenue increases are collected from all taxpayers rather than from selected groups. Rate increases, however, have many undesirable effects. In particular, they would exacerbate existing serious distortions of economic decisions resulting from the current tax system. They may also be perceived as unfair because they most heavily affect individuals and corporations who benefit the least from tax preferences.

Sales and Excise Taxes. Another alternative for raising revenue is to place new taxes on consumption or increase existing excise taxes. A significant amount of revenue could be raised by imposing a new general sales tax, in the form of either a retail sales tax or a value-added tax

(VAT). For example, if a 5 percent VAT or retail sales tax were introduced in 1987 and included exemptions for food, housing, and medical care, it could raise about $39 billion in 1987 and $76 billion by 1990.

A sales tax would most likely cause a one-time increase in prices and would impose proportionately greater burdens on low-income households because consumption usually takes a larger share of their income.

More selective excise taxes, such as energy taxes, could also raise significant amounts of revenue. For example, a 5 percent broad-based tax on energy consumption would raise $10 billion in 1986, increasing to $18 billion by 1990. Additional revenues could also be raised by increasing selective excise taxes or delaying scheduled reductions in taxes on tobacco and telecommunications.

The implementation of any new tax has the disadvantage that it may impose significant administration costs, particularly if it is at all complex. Regulations have to be written, new revenue agents must be hired and trained, and taxpayers must bear new compliance costs.

Base-Broadening. Another approach to raising income tax revenues is to broaden the tax base. Over the years, the base of the income tax has been narrowed considerably by establishing or expanding deductions, exclusions, and credits. For example, since 1950 taxable personal income has fallen from over 90 percent of total personal income to about 80 percent in 1984. The base of the corporate income tax as a share of corporate profits has also declined over time, and new tax credits have further reduced tax collections. The proliferation of tax preferences has

resulted in an increasingly complex tax system, which has led to a growing public perception that the tax laws are unfair. This erosion of the tax base has necessitated higher rates in order to raise adequate federal government revenues.

Reducing or eliminating tax preferences could raise large amounts of revenue. For example, adding employer-paid health insurance to the tax base would raise about $17 billion in 1986, and $39 billion by 1990. Repeal of the investment tax credit and reduction of the subsidy element of the Accelerated Cost Recovery System would add about $15 billion to revenues in 1986, increasing to about $65 billion by 1990. A proposal to reduce itemized deductions by 10 percent and most other tax preferences by 20 percent (including lengthening depreciation lives by 20 percent) would raise $8 billion in 1986, rising to $52 billion in 1990.

Base-broadening generally would simplify tax planning by reducing opportunities for legal tax shelter activity, and could also reduce the costs of income tax compliance and enforcement. Further, for any revenue target, rates on a broader base can be lower than those on a narrower base, reducing the distortions in the system. Adjustment problems caused by removing preferences, however, may be severe in the short run, as labor and other resources shift out of sectors that lose tax advantages. Moreover, some investors would suffer windfall losses. Accomplishing base-broadening by small reductions in many preferences instead of by eliminating selected tax benefits would reduce these costs

of adjustment. At the same time, they could have negative effects by failing to distinguish between outmoded tax incentives and provisions that promote important public objectives.

CONCLUSION

The foregoing discussion clearly indicates that the choices are not easy, but delay will only make the choices more difficult in the future. Choosing the overall size and composition of the federal budget involves some of the most profound collective value judgments that a society can make. But whatever the choice, it must be paid for. Attempts to obscure the costs through borrowing can only postpone the inevitable reckoning.