

Statement of  
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before the  
Committee on the Budget  
United States Senate

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There should be no release of  
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Mr. Chairman, I am pleased to testify today before this Committee on the outlook for the economy and the budget. We are releasing at the hearing this morning the new Congressional Budget Office report, The Economic and Budget Outlook: Fiscal Years 1986-1990.

The budget estimates contained in this report have not changed greatly from those published by CBO last August. The rate of economic growth in calendar year 1984 was 6.8 percent, the highest since 1951. Despite the vigor of the economy, the deficit-GNP ratio in fiscal 1984 was, at 5.2 percent, the second highest in our postwar history, clearly illustrating the extreme imbalance in our fiscal policies. Assuming historical rates of economic growth in the future, current law implies a steadily rising total deficit that nears \$300 billion by 1990. The deficit does, however, remain constant relative to GNP at slightly more than 5 percent, which represents an improvement over last February's projection of a steadily rising deficit-to-GNP ratio. This improvement results from the enactment of the "downpayment" on the deficit during calendar year 1984. Although the deficit-GNP ratio has been stabilized, its high level implies rapid growth in the ratio of the outstanding debt to GNP throughout the projection period.

This rapidly growing debt, in turn, implies a steadily growing interest burden that is itself a major component of our budget problem. More important, current fiscal policy suggests that the living standards of future generations of Americans will be gradually lowered compared with what they could be if fiscal policy were more prudent. CBO's projections

imply that the economy will continue to expand in the face of a steadily growing debt burden; in fact, in the very short run the growing deficit may even add slightly to the rate of expansion. Because the assumed combination of growing deficits and relative economic prosperity is without precedent in peacetime history, however, CBO's relatively optimistic economic projections must be put forward with considerable uncertainty.

#### RECENT ECONOMIC DEVELOPMENTS

Real GNP grew at a rapid 5.6 percent rate between the last quarters of 1983 and 1984, only slightly less than in the first year of recovery, and the unemployment rate declined to 7.2 percent by the fourth quarter of the year. Despite the sharp drop in **unemployment**, the inflation rate averaged about 4.0 percent during 1984, little changed from the moderate pace achieved in the previous year. Economic growth was led by rapid growth in consumer spending and a surge in business investment spending, both of which continued to benefit from the tax cuts enacted earlier. The lagging trade sector, however, remained a serious drag on the economy.

Economic growth was particularly strong in the first half of 1984, but slowed to a more sustainable pace thereafter. With reduced demands, interest rates declined and inflation remained moderate in the second half of 1984. At year-end, business firms also seemed to have had some success in reducing excess inventories. Thus, conditions now appear to be set for continued economic expansion with little increase in inflationary pressure.

## THE CBO ECONOMIC PROJECTIONS

CBO's baseline economic projections are composed of two parts: a two-year forecast, conditional on specific policy assumptions; and medium-term projections, which show a smooth growth trend derived from average historical experience.

### The Short-Run Economic Forecast

As in the past, CBO's economic forecast for the next two years incorporates an assumption of unchanged federal budget policies. In regard to monetary policy, the forecast assumes that the growth in the money aggregate M1 will be 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. In addition to these policy assumptions, the price of imported oil is projected to average about \$1.50 per barrel below last year's price and the value of the dollar in international exchange markets is assumed to decline moderately from current levels, so that its average value this calendar year will be about the same as last year.

Based on these assumptions, real growth is now forecast to be about 3½ percent over the four quarters of 1985 and slightly less by 1986. The unemployment rate is projected to decline gradually to 6.9 percent in 1986. Given this projected soft landing, inflation is expected to rise only fractionally from about 4.0 percent last year to 4.6 percent by 1986. The three-month Treasury Bill rate in calendar year 1985 is about one percentage point below last year and rises only slightly in 1986.

### 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 be precisely equal to the average growth rate in eight-year periods following earlier postwar recessions. As a result, real GNP growth averages about 3.4 percent a year in the 1987-1990 period, and productivity growth in the nonfarm business sector averages about 2.2 percent. With these growth rates, the unemployment rate declines slowly to 6.2 percent in calendar year 1990. Inflation, as measured by the GNP deflator, averages 4.2 percent in the 1987-1990 period while the three-month Treasury bill rate averages 8.2 percent, or 4.0 percent after adjustment for inflation (see Table 1 and Figure 1).

### Uncertainties in the Economic Outlook

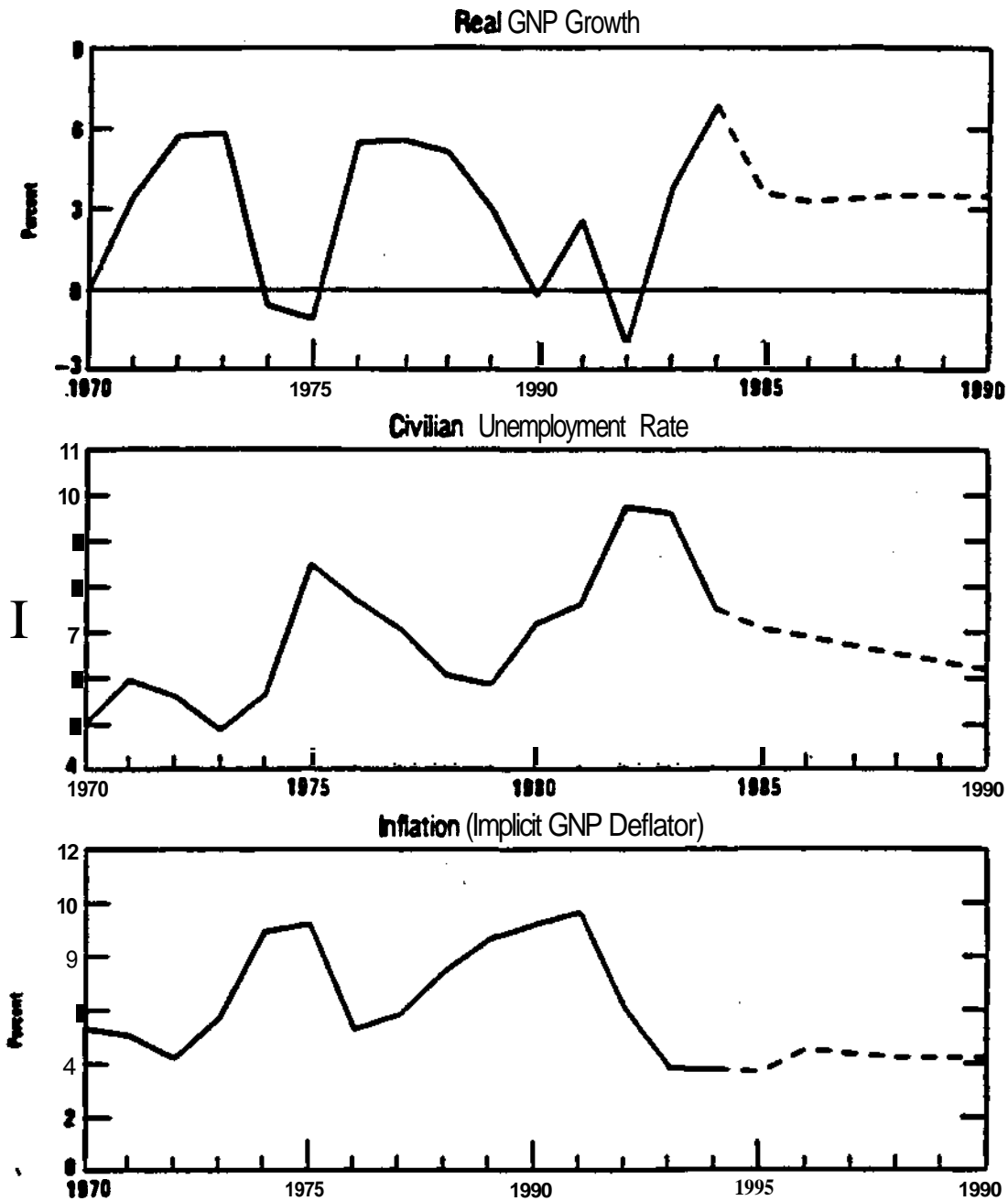
The economy's performance could easily turn out to be much better or worse than CBO's projections indicate. At present, the major uncertainties in the short run are related to inventories, oil prices, and interest rates. Some analysts fear that a temporary reduction in output growth will be necessary 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. Additional risks include a drop in capital inflows from abroad leading to a decline in the dollar, a rise in domestic inflation, and increased pressure on interest rates. It is also

possible that repercussions could occur as a result of the financial stress being experienced in agriculture and other sectors. CBO has not included any such events in its short-run forecast. Although the baseline projection

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

	<u>Actual</u> 1984	<u>Forecast</u>		1987	1988	1989	1990
		1985	1986				
GNP (billions of current dollars)	3661	3927	4238	4567	4921	5301	5711
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

FIGURE 1. MAJOR ECONOMIC ASSUMPTIONS



SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis, U.S. Department of Labor, Bureau of Labor Statistics, Congressional Budget Office.

for the out-years does not explicitly incorporate a recession or an inflationary shock of any kind, it does not imply that such events will not occur. Because the timing of such events is impossible to forecast so far in advance, our projections simply smooth out real growth and inflation rates over the period. If it were certain there would be no recession, a somewhat higher annual growth rate would be appropriate.

### 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 budget outlook has not changed materially from CBO's projections last August. In fact, the projected total deficits for 1986-1989 are very close to those calculated six months ago. 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.

Despite the projected rise in the absolute size of the federal deficit, projected total deficits as a percentage of GNP for 1986-1990 under current laws and budget policies are fairly stable at around 5.2 percent--a sharp contrast to our projections of a year ago when the deficit was rising as a



TABLE 2. BASELINE BUDGET PROJECTIONS (By fiscal year)

	1984	1985	Projections				
	Actual	Base	1986	1987	1988	1989	1990
In Billions of Dollars							
Baseline with Budget Resolution Defense Authority <u>a/</u>							
Revenues	666	735	788	855	934	1,005	1,088
Total outlays <u>b/</u>	852	949	1,003	1,088	1,183	1,276	1,384
Total deficit <u>b/</u>	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
As a Percent of GNP							
Baseline with Budget Resolution Defense Authority <u>a/</u>							
Revenues	18.6	19.1	19.0	19.1	19.3	19.3	19.4
Total outlays <u>b/</u>	23.8	24.6	24.1	24.3	24.5	24.5	24.7
Total deficit <u>b/</u>	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
Reference: GNP (in billions of dollars)	3,581	3,855	4,158	4,483	4,830	5,204	5,606

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

percentage of GNP. This improvement results from the enactment of the Deficit Reduction Act and other measures.

### Baseline Projections

CBO's baseline projections are designed to show what would happen to the federal budget if current policies were continued into the future. For revenues and for entitlements and other mandatory spending items, current policies are largely defined by the laws now in effect. For discretionary spending, however, the definition of current policy is not as clear, since appropriations are made for only one year at a time. For our baseline projections of discretionary spending programs, CBO uses the following conventions:

- o The baseline projections for nondefense appropriations are generally based on fiscal year 1985 funding levels as enacted by the 98th Congress, with future increases to keep pace with inflation.
- o The projections for defense appropriations are based on enacted 1985 funding levels, with future increases to bring defense budget authority to the levels assumed in the 1985 budget resolution, as extrapolated through 1990. This means that defense budget authority would grow at an average rate of 5½ percent in real terms--after adjustments for projected inflation.

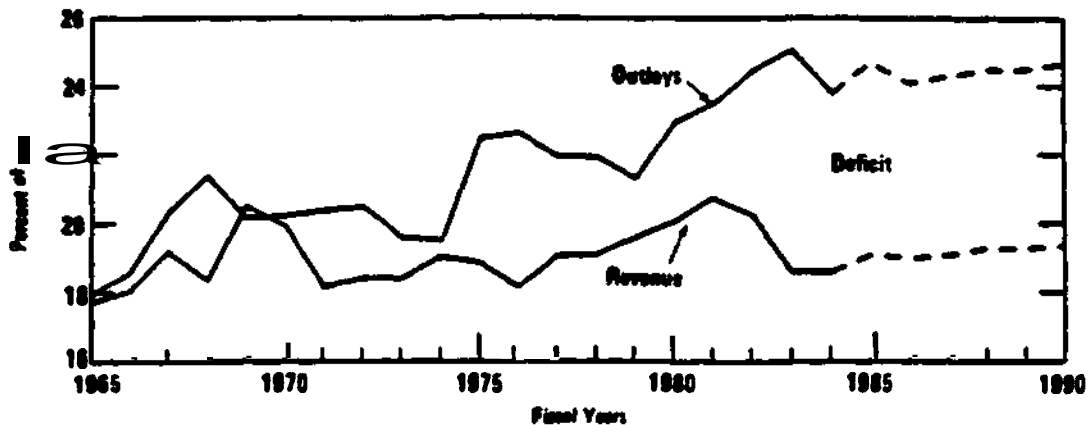
While these conventions do not necessarily represent a detailed program-by-program projection of the budget priorities and policies contained in the 1985 appropriations, they appear generally to be consistent with recent overall budget decisions.

Under CBO's baseline assumptions, revenues are projected to rise about 10 percent this year, to \$735 billion, and to continue rising slightly faster than GNP through the remainder of the decade. As a percentage of GNP, revenues were 18.6 percent in 1984 and are projected to be 19.1 percent this year, rising to 19.4 percent in 1990. Total outlays--including off-budget spending--are projected to be nearly \$950 billion this year and to rise to \$1,384 billion by 1990. In the 1985-1990 period, federal spending under current policies would fluctuate in a narrow range between 24.1 percent and 24.7 percent of GNP, close to the 1983 postwar record (see Figure 2).

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FIGURE 2. REVENUES AND OUTLAYS

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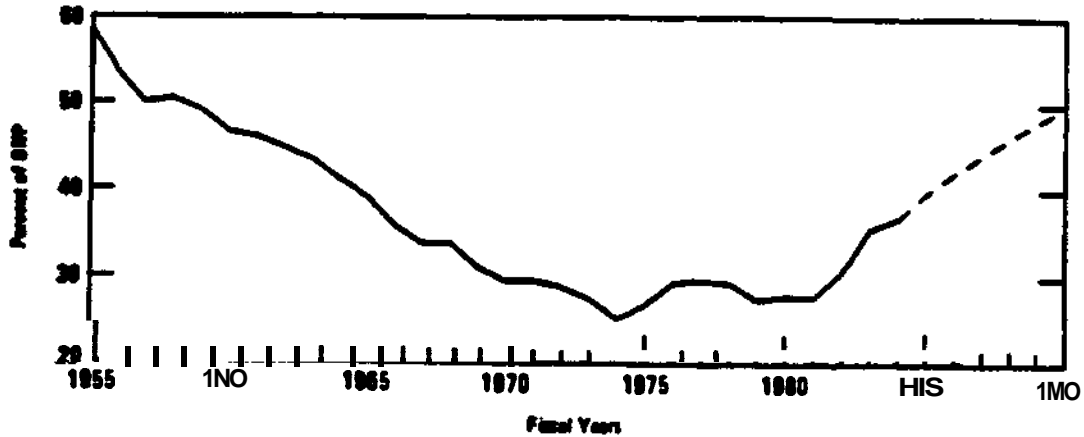
SOURCE: Congressional Budget Office.

The continued large and growing gaps between projected revenues and outlays means that federal borrowing needs will remain extremely large for an indefinite period. Under CBO's baseline assumptions, federal debt held by the public is projected to grow from \$1.3 trillion at the end of fiscal year 1984 to \$2.8 trillion by the end of 1990. This rapid accumulation of debt, which is outpacing the growth in the economy by a wide margin, would raise the debt held by the public as a percentage of GNP from under 30 percent during the 1970s to nearly 50 percent by 1990 (see Figure 3). An increase of this magnitude in the debt-to-GNP ratio has not occurred since World War II.

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FIGURE 3. FEDERAL DEBT HELD BY THE PUBLIC

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SOURCE: Congressional Budget Office.

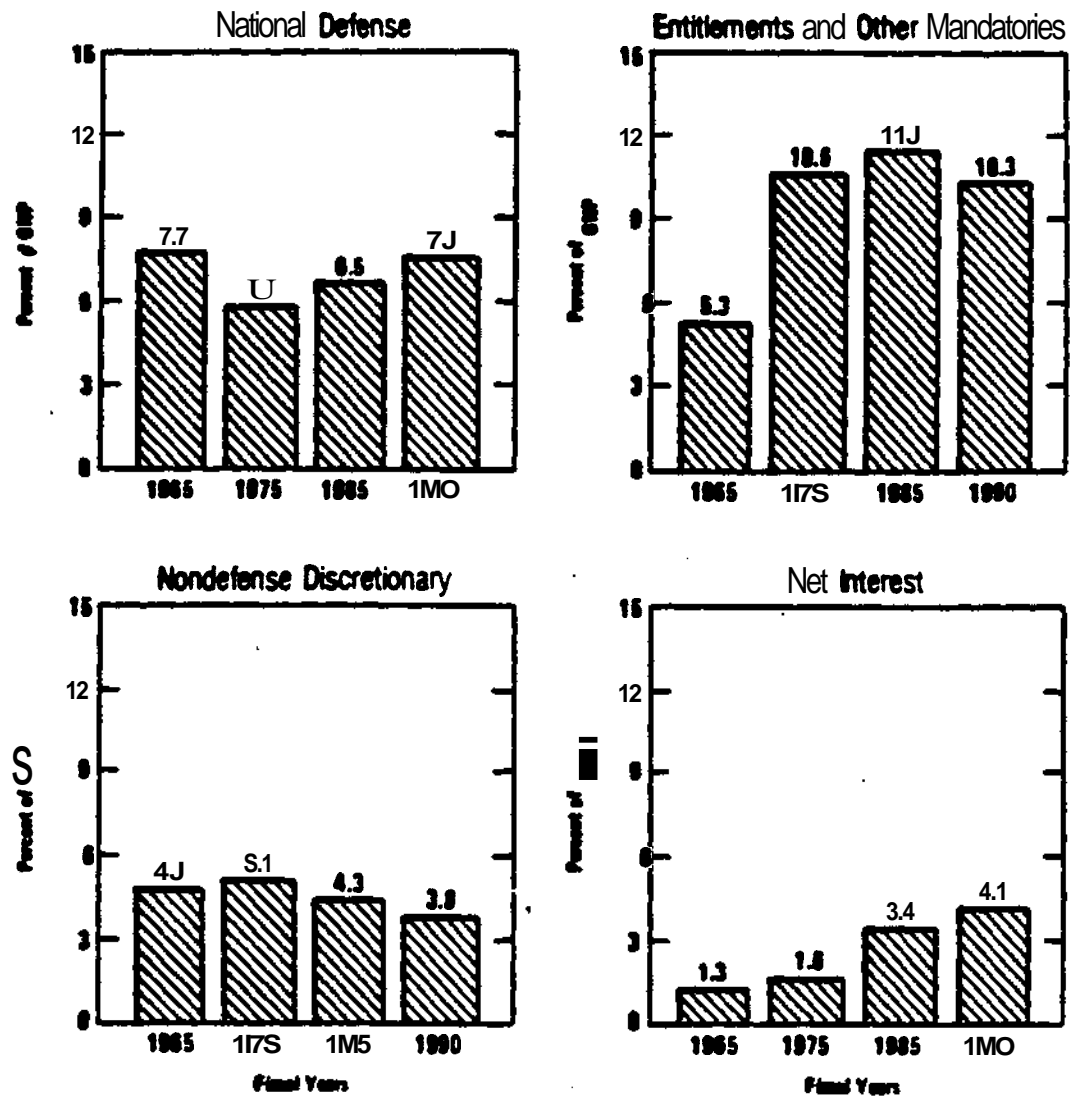
### Changes in the Composition of Revenues and Spending

The composition of federal revenues is projected to change only slightly over the next five years if laws remain unchanged (see Table 3). Individual income and social insurance taxes and contributions are projected to constitute a record 53 percent of total revenues by 1990, continuing a long-established trend toward more reliance by the federal tax system on personal taxes. Corporate income taxes would also increase as a share of total taxes, from 8.5 percent in 1985 to close to 10 percent in 1990, but would still be far below the average of 21 percent in the 1960s and 15 percent in the 1970s. Reliance on corporate income taxes as a revenue source has been diminishing steadily as a result of legislated tax reductions and a general downward trend in the share of GNP going to economic profits.

Projected changes in the composition of federal spending under current policies are more substantial. The most rapidly growing category of spending in the baseline is net interest. With mounting borrowing needs and no reduction in inflation-adjusted interest rates after 1986, federal interest costs are projected to grow by \$100 billion over the next five years, from \$130 billion in 1985 to \$230 billion in 1990. The net interest share of total spending would increase from 13.7 percent to 16.6 percent. In relation to GNP, net interest outlays have more than doubled in the past decade, rising from 1.6 percent of GNP in 1975 to 3.4 percent in 1985, and are projected to reach 4.1 percent by 1990 (see Figure 4).

Assuming that defense appropriations rise in line with the 1985 budget resolution targets for 1986 and beyond, national defense outlays would

FIGURE 4. THE COMPOSITION OF FEDERAL SPENDING



SOURCE: Congressional Budget Office.

TABLE 3. BASELINE REVENUE AND OUTLAY PROJECTIONS BY SOURCE OR MAJOR CATEGORY (By fiscal year, in billions of dollars)

	1984 Actual	1985 Base	Projections				
			1986	1987	1988	1989	1990
<b>Revenues</b>							
Individual Income Taxes	298	333	361	393	432	471	515
Corporate Income Taxes	57	63	71	88	96	102	107
Social Insurance Taxes	239	266	284	301	333	358	389
Excise Taxes and Other Revenues	72	74	72	72	72	74	77
Total Baseline Revenues	666	735	788	855	934	1,005	1,088
<b>Outlays</b>							
National Defense Entitlements and Other Mandatory Spending	227	252	282	313	347	384	424
Social Security	174	185	196	209	224	238	254
Medicare	61	69	76	85	95	107	119
Other	159	152	173	183	191	197	204
Subtotal	396	436	445	477	510	542	577
Nondefense Discretionary Spending	153	168	174	182	191	200	211
Net Interest	111	130	146	163	186	206	230
Offsetting Receipts	-45	-48	-52	-56	-59	-62	-65
Budget Outlays	342	938	995	1,080	1,174	1,270	1,378
Off-Budget Federal Entities	10	11	9	8	8	6	6
Total Baseline Outlays	852	949	1,003	1,088	1,183	1,276	1,384

increase by \$172 billion during the next five years, from \$252 billion in 1985 to \$424 billion in 1990. Of this projected increase, \$81 billion would result from the assumed real growth in defense budget authority, \$62 billion from pay increases and other inflation adjustments, and \$30 billion from previous increases in defense appropriations. As a share of total federal spending, national defense outlays would rise from 26.5 percent in 1985 to 30.7 percent in 1990. The ratio of national defense outlays to GNP would also increase substantially, reaching 7.6 percent by 1990, up a full percentage point from the 1985 level and almost two percentage points above the 1975 level, but still somewhat less than the 1965 level.

Nondefense programs would grow by \$162 billion under current laws and policies, but would shrink in relative size. Most of these increases are to cover projected cost-of-living adjustments for Social Security and other indexed benefits, caseload increases, expected increases in medical costs, and inflation adjustments in discretionary programs. Because these increases are well below the rate of increase in total outlays, the share of the budget made up by these programs would decline from 60 percent in 1985 to 53 percent in 1990.

Perhaps the most important point one can make about the spending side of the budget is that very few programs are responsible for the bulk of federal outlays. Under CBO's projections, spending for national defense, Social Security, Medicare, and net interest would comprise 74 percent of total outlays and would be equivalent to 94 percent of total revenues by 1990.



### Comparison of CBO and Administration Baseline Projections

The CBO baseline and OMB current services budget projections are very similar through 1988, as shown in Table 4. OMB projects somewhat higher deficits for 1935-1987 under its interpretation of current policies, and CBO projects higher deficits for 1989-1990. The projected total deficits for 1988, however, are almost identical--\$249 billion for CBO versus \$248 billion for OMB.

CBO is now examining the Administration's budget estimates to determine how much of the differences shown in Table 4 result from differences in the definition of current policy and how much from differences in economic assumptions or technical estimating methods. While the analysis will take us a few weeks to complete, it is clear that the Administration's economic assumptions produce more revenues and lower interest costs than the CBO baseline assumptions. The Administration's higher growth assumptions, and only slightly lower inflation assumptions, result in somewhat higher nominal GNP estimates throughout the 1986-1990 period, as shown in Table 5. These higher nominal GNP assumptions in turn produce marginally higher revenue estimates. Similarly, the Administration's lower interest rate assumptions result in lower interest outlays, especially in 1989 and 1990.

The most notable difference in the definition of current policy is for national defense. The OMB current services projections for national defense are last August's midsession review estimates reflecting the Rose Garden

plan, while CBO uses the 1985 budget resolution budget authority targets for its baseline. The OMB definition results in higher outlays throughout the projection period, ranging from \$13 billion in 1986 to \$21 billion in 1988.

Uncertainty of Budget Estimates

Budget projections are always somewhat speculative. Events may not work out as assumed, particularly the projected developments in the economy. The economy could perform either better or worse than CBO has

TABLE ft. COMPARISON OF CBO BASELINE AND OMB CURRENT SERVICES PROJECTIONS (By fiscal year, in billions of dollars)

	1985	1986	1987	1988	1989	1990
Revenues						
CBO baseline	735	788	855	93ft	1005	1088
OMB current services	737	79ft	864	952	1030	1108
Difference	2	6	9	18	26	21
Total Outlays <u>a/</u>						
CBO baseline	949	1003	1088	1183	1276	138ft
OMB current services	960	1025	1109	1200	1263	1333
Difference	11	21	21	17	-1ft	-51
Total Deficit <u>a/</u>						
CBO baseline	21ft	215	233	249	272	296
OMB current services	224	230	246	248	233	22ft
Difference	9	16	12	-1	-39	-72

a/ Includes off-budget spending.

projected. To estimate the possible variance for our baseline budget projections, we prepared two alternative economic paths. Under a high-growth path, in which the economy matches the strong growth record of the 1960s, the total deficit would decline to \$126 billion, or 1.9 percent of GNP by 1990. Under a low-growth path, in which the economy undergoes a recession in 1987, the total deficit balloons to \$425 billion, or 8.7 percent of GNP by 1990.

TABLE 5. COMPARISON OF CBO AND OMB ECONOMIC ASSUMPTIONS  
(By calendar year)

	1985	1986	1987	1988	1989	1990
Nominal GNP (\$ billions)						
CBO	3,927	4,238	4,567	4,921	5,301	5,711
Administration	3,948	4,285	4,642	5,017	5,399	5,780
Difference	21	47	75	96	98	69
Real GNP Growth Rate (%)						
CBO	3.5	3.2	3.3	3.4	3.4	3.4
Administration	3.9	4.0	4.0	4.0	3.9	3.6
Difference	0.4	0.8	0.7	0.6	0.5	0.2
GNP Deflator (% change)						
CBO	3.6	4.6	4.4	4.2	4.2	4.2
Administration	3.8	4.4	4.2	3.9	3.6	3.3
Difference	0.2	-0.2	-0.2	-0.3	-0.6	-0.9
3-Month Treasury Bill Rate						
CBO	8.3	8.7	8.2	8.2	8.2	8.2
Administration	8.1	7.9	7.2	5.9	5.1	5.0
Difference	-0.2	-0.8	-1.0	-2.3	-3.1	-3.2

## THE ECONOMIC EFFECTS OF DEFICITS

What are the economic effects of the deficits implied by the CBO projections? Economists cannot answer this question precisely. I will discuss three aspects of the deficits: their size in relation to historical savings trends, the costs associated with financing such deficits, and the impact of the build-up in government debt on the living standards of future generations.

### Savings and Deficits

Since 1950, net private savings in the U.S. economy have averaged about 7.2 percent of GNP. State and local governments have registered an additional small surplus. Net foreign investment was negligible in this period. Federal deficits absorbed about 1.1 percent of GNP on a national income accounts basis, leaving total private and public saving available for domestic investment equal to about 6.5 percent of GNP (see Table 6). CBO's baseline budget projection for the 1985-1990 period now indicates that the federal deficit-to-GNP ratio in the 1985-1990 period will average 4.6 percent of GNP, on the same national income accounts basis. Thus, the share of net domestic savings absorbed by deficits would be many times higher than the average of the past, if savings behavior follows historical trends. Even with estimates of net private savings well above their level of recent years and state and local surpluses near their record high, only about 4.0 percent of GNP would be left for domestic investment. Thus, if

TABLE 6. NET SAVINGS AND INVESTMENT FLOWS AS PERCENTS OF GNP (NIPA Basis)

Period	(1) Net Private Domestic Savings	(2) State and Local Surplus	(3) Federal Deficit	(4) Net Domestic Savings Avail- able for Domestic in- vestment: (1)+(2)-(3)	(5) Net Private Domestic Investment	(6) Net Domestic Savings Shortfalls -(5)-(4) = Net Foreign Investment
1950-1959	7.2	-.2	-.1	7.1	7.1	-.1
1960-1969	7.8	0	.3	7.5	7.0	-.5
1970-1979	7.2	.8	1.8	6.2	6.4	-.1
1980-1984 <u>a/</u>	6.0	1.3	3.9	3.4	4.1	.7
Average						
1950-1984	7.2	.4	1.1	6.5	6.4	-.1
1985-1990 <u>b/</u>	7.2	1.4	4.6	4.0	6.4	2.4

a/ BEA estimates are used for 1984 state and local surplus and 1984 federal deficit.

b/ Only the federal deficit is a CBO projection. Net private domestic savings and net private domestic investment shares of GNP are assumed for illustrative purposes to be at their averages of the 1970s, while the state and local surplus is assumed to maintain its high estimated share of GNP in 1984. Columns 4 and 6 are calculated from the other figures.

Details may not appear consistent with totals because of rounding.

investment spending only matched the historical average, the shortfall of domestic savings would be about 2½ percent of GNP.

This large gap between domestic savings and investment could be filled only by raising domestic savings sharply above the historical average, by attracting inflows of foreign capital of record proportions, or by reducing federal deficits. Otherwise, investment spending would be very weak.

Because savings with current policy are likely to remain scarce relative to planned investment, the competition for funds will be more intense. This will lead to high real interest rates since they are the reward paid to savers and a filter through which scarce funds are channeled for alternative uses.

#### Outlays for Interest on the Debt

As indicated earlier, if budget policies are not changed, the outstanding federal debt will rise dramatically. Federal spending for interest payments would also rise sharply, thereby limiting federal resources available for other spending programs. Just how fast interest payments will rise depends 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.

If deficits become sufficiently high in the long run or interest rates rise significantly, interest costs may rise so rapidly that it is no longer

politically feasible to offset their growth by raising taxes or cutting programs. At that point, there is a danger that the deficit and the associated debt outstanding will explode relative to GNP. Under these circumstances, there is a strong temptation to finance government by creating money rather than by further borrowing. The result would, of course, be highly inflationary. Fortunately, under current policies, the projected growth of non-interest spending relative to the growth in receipts is sufficiently low to offset the growth in interest costs and to stabilize the deficit/GNP ratio at slightly over 5 percent of GNP.

#### Long-Run Effects of Deficits

One consequence of persistent large deficits about which there seems to be little disagreement is their adverse effect on future generations. If deficits were financed entirely through domestic savings, rising federal debt would begin supplanting more and more private debt and equity in the portfolios of private investors. Slower growth of the private capital stock would result in lower productivity than would occur with smaller deficits, and the income of future generations would be lower. If the deficits were partly financed by inflows of foreign savings, that would imply a growing debt owed to foreigners. While investment could be maintained at higher levels than would be possible without the inflows, U.S. residents would enjoy a shrinking proportion of the production generated here because of rising interest and dividend payments abroad.

Thus, while reducing deficits may be painful for our generation, failure to reduce them will affect future generations. Of course, to what extent one chooses to benefit the current generation at the expense of future ones call for a value judgment rather than an economic one.

### GOALS FOR DEFICIT POLICY

There is no easy way to set a goal for deficit reduction. The traditional goal of a balanced budget seems out of reach in the short run. Moreover, because the CBO estimates imply that the economy will be nearing full capacity by the end of the projection period, the goal of balancing the high-employment budget is only slightly less difficult. Further, there is a danger in placing too much emphasis on any specific goal. The public might believe that anything short of that goal represents absolute failure or that anything exceeding it represents unnecessary program cuts or tax increases.

The most important point to make about deficit reduction is that every little bit helps a lot because of the long-run indirect effect on interest costs. Given the interest rate assumptions underlying the CBO forecast and projections, a one dollar cut in spending programs or a tax increase of one dollar lasting for the entire 1985-1990 period implies an interest saving during 1990 of over 70 cents.

The characteristics of the cut are also sometimes as important as its dollar value. For example, it is relatively easy to cut spending in the short run by postponing the repair of public works. But such spending must be



made eventually, and therefore the short-run cut may have little relevance to the long-run fiscal problem. In contrast, a relatively small change in entitlements or tax laws may have little impact on deficits in the short run, but its effects may grow rapidly in the long run. In theory, such a fundamental change should have more impact on financial markets than a cut that saves more money in the short run but is not sustainable.

Notwithstanding these important qualifications, it is possible to state a deficit reduction goal that has some appeal. As I noted earlier, a large part of the budget problem is related to rapidly growing interest costs that are, in turn, the result of a rapidly growing debt-to-GNP ratio. If the debt-GNP ratio 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 would thus be converted into a large part of the solution and the budget dilemma would appear to be much more tractable.

If the ratio of debt held by the public to GNP could be stabilized in the last year of the budget resolution's three-year planning horizon—that is to say, if the debt-GNP ratio at the end of fiscal year 1988 could be held to its level at the end of 1987—it is likely that it would decline in subsequent years. This goal implies a deficit of \$145 billion in 1988, which could be attained with program cuts or tax increases of \$30 billion in 1986, \$55 billion in 1987, and \$90 billion in 1988. <sup>1/</sup> This is approximately the same

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1. The figures would be only slightly different if the debt target excluded Treasury securities held by the Federal Reserve System.

time profile of cuts manifested by the downpayment on the deficit in 1984, although those cuts were smaller in magnitude. There are obviously a variety of time patterns of cuts that are consistent with the same 1988 goal. If policy changes of the specified amounts were achieved, interest savings of \$2 billion in 1986 and \$14 billion by 1988 would also result. If market interest rates responded favorably to the plan, the interest savings would, of course, grow and the debt-GNP ratio would be already declining in 1988.

The costs of delay are very high (see Table 7). If nothing is done in 1986, but the same plan is implemented in 1987, the interest savings in 1988 are lowered by \$8 billion. This saving is more than enough to finance the \$7 billion that CBO projects will be spent under current law on the entire budget function entitled Administration of Justice in 1988.

Again, I want to emphasize that, by describing one particular deficit reduction plan, CBO does not wish to rule out plans implying more deficit reduction. If the debt-GNP ratio could be put on a declining path earlier, a greater margin of safety would result in the event that CBO's long-term economic assumptions turn out to be overly optimistic.

## CONCLUSION

If the Congress is to reduce the deficit significantly, it must do this either by increasing tax burdens or by reducing outlays for major spending programs. The CBO publication Reducing the Deficit, which will be available on the 20th of this month, will provide the Congress with

estimates of the savings that would be achieved with a wide variety of both spending and taxing options. CBO cannot recommend any one approach, of course, because such policies involve value judgments that are properly decided by the political process.

TABLE 7. THE COSTS OF DELAY (By fiscal year, in billions of dollars)

	1986	1987	198S	1989	Total
Policy Savings from Baseline					
Baseline	--	--	--	--	--
Path 1 (Start in 1986)	-30	-55	-90	-100	-275
Path 2 (Delay until 1987)	--	-30	-55	-90	-175
Interest Savings					
Baseline	--	--	--	--	--
Path 1	-2	-6	-14	-25	-47
Path 2	--	-2	-6	-14	-21
Total Deficit					
Baseline	215	233	249	272	
Path 1	183	172	145	147	
Path 2	215	202	188	168	
Debt/GNP (percent)					
Baseline	41.8	44.0	46.0	47.9	
Path 1	41.1	41.9	41.9	41.7	
Path 2	41.8	43.3	44.0	44.1	