CBO TESTIMONY

Statement of
June E. O'Neill
Director
Congressional Budget Office

on
The Administration's Budgetary Proposals

before the
Committee on the Budget
U.S. House of Representatives

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NOTICE

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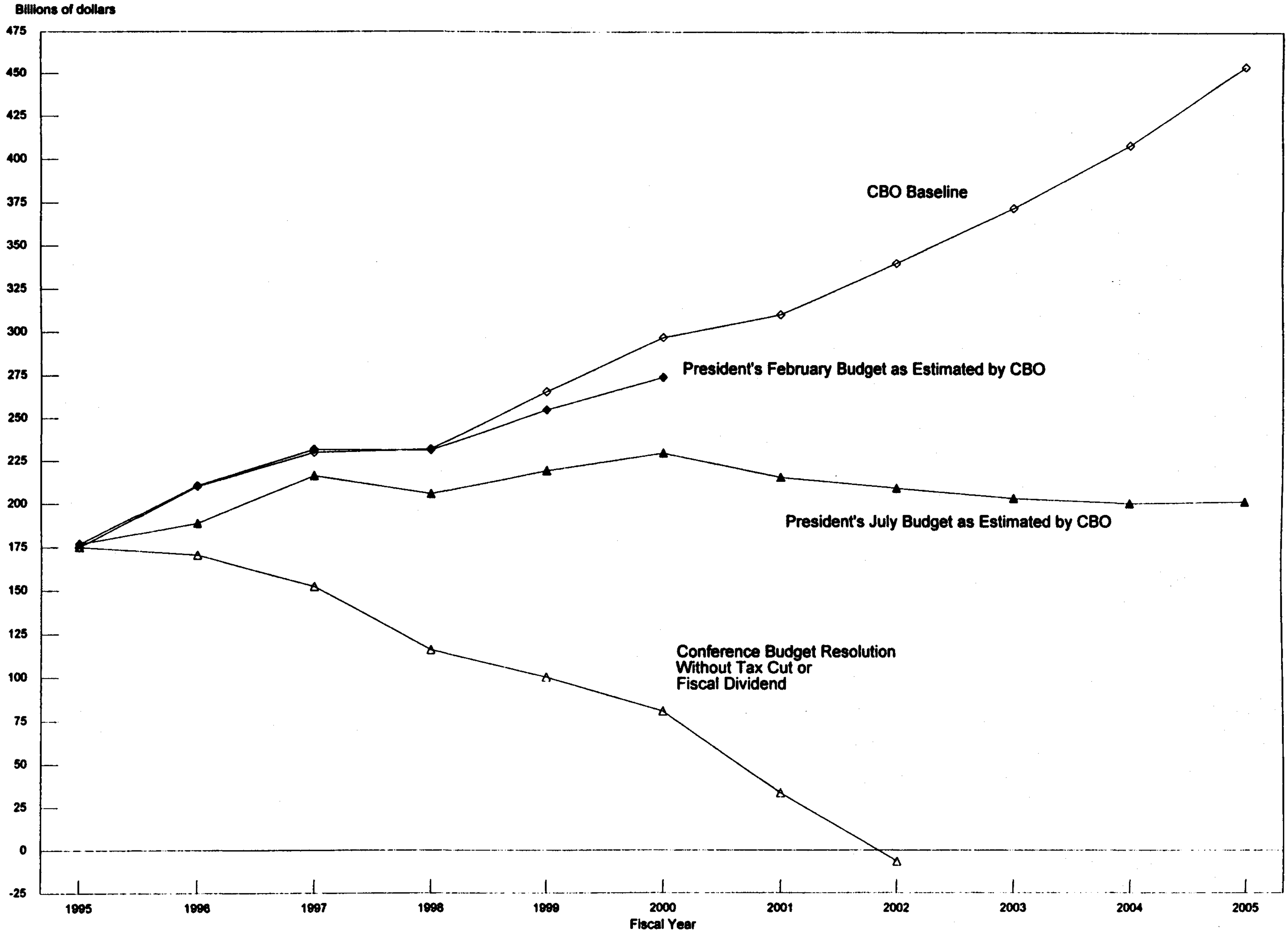
CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

Chairman Kasich and Members of the Committee, I am pleased to be with you this morning to review the budgetary plan that the Clinton Administration set forth in the *Mid-Session Review of the 1996 Budget* issued on July 31. The budget that the Administration submitted in February for fiscal years 1996 through 2000 would not have substantially changed the projected budget deficits. By contrast, the Administration's revised budgetary plan for fiscal years 1996 through 2005 includes reductions in corporate subsidies and additional spending savings designed to make large reductions in the federal deficit (see Figure 1). In my statement today, I will describe the Congressional Budget Office's (CBO's) preliminary assessment of the Administration's new plan and explain the differences between CBO's estimates and those of the Administration.

CBO previously analyzed the initial version of the Administration's amended budget--released on June 13--in testimony that I presented to the Joint Economic Committee. The assessment that I am providing today has been revised to incorporate changes the Administration has made to its proposals since June 13. However, because those changes are relatively minor, this analysis differs from our earlier one only in the details.

CBO's estimates of the President's budget are based on CBO's April 1995 baseline projections. CBO is in the process of updating those projections, but the new baseline will not be released until later this month. Because both the budget resolution adopted by the Congress and CBO's estimate of the President's February

FIGURE 1. COMPARISON OF PROJECTED DEFICITS



SOURCE: Congressional Budget Office.

budget were based on CBO's April projections, using that same baseline for the estimate of the President's July budget makes it easier to compare the changes in fiscal policy proposed in the two budgets submitted by the President and in the budget resolution. In addition, CBO anticipates that the revisions it is currently making to its baseline projections will not substantially affect the analysis of the President's budget.

The baseline deficits for 1995 and 1996 will be lower than CBO projected in April. The deficit in 1995 is expected to be between $160 billion and $165 billion instead of $175 billion. Nevertheless, CBO's August projections of the deficit in the years after 1996 are likely to be quite similar to the earlier projections. Thus, using CBO's August baseline assumptions would bring CBO's estimate of the deficits under the President's policies closer to the Administration's estimates in the years 1995 and 1996, but would not substantially affect the estimates for later years.

THE ADMINISTRATION'S BUDGETARY PLAN

The budget submitted by the Administration in February recommended changes in policies that would have reduced the cumulative deficit by about $30 billion between 1995 and 2000. The President proposed tax changes that would shrink revenues by

$60 billion over the six-year period. The major tax initiative would provide for tax relief in the form of a nonrefundable tax credit for families with young children, a deduction for postsecondary education and training expenses, and an expansion of individual retirement accounts. Proposed savings in Medicare (stemming primarily from extending provisions of the Omnibus Budget Reconciliation Act of 1993 that expire at the end of 1998) and other mandatory programs offset only about $17 billion of the revenue loss. The President also proposed to sell assets that CBO estimated would produce almost $8 billion in receipts. Finally, compared with CBO's baseline, which allows for inflation in discretionary programs after 1998, the President's February budget would have reduced discretionary spending by a cumulative total of $67 billion, with most of the reductions occurring in 1999 and 2000.

The President's July budgetary plan retains most of the elements of the February budget. In addition, it extends the fiscal horizon through 2005 and assumes additional savings intended to achieve budgetary balance in nine years. The major new areas targeted for reduction are:

- Discretionary spending--$119 billion in cuts in 2005 and $513 billion in cumulative reductions over the 1996-2005 period compared with CBO's baseline with discretionary inflation after 1998;

- Medicare--$66 billion in 2005 and $289 billion over the 1996-2005 period;

- Medicaid--$19 billion in 2005 and $105 billion in total;

- Welfare programs--$8 billion in 2005 and $57 billion in total; and

- Corporate subsidies--$6 billion in 2005 and $43 billion in total.

The Administration's July package also contains several health initiatives. In addition to providing for spending reductions in Medicare and Medicaid, the Administration proposes a number of new benefits, including subsidies of health insurance for people unemployed up to six months, grants to states for home- and community-based long-term care, an Alzheimer's respite care benefit within Medicare, and elimination of the copayment for mammograms. The Administration would also increase the fraction of health insurance costs that the self-employed can deduct for income tax purposes from 30 percent to 50 percent.

As explained by the staff of the Office of Management and Budget (OMB) in June, the additional budgetary savings included in the Administration's new plan are "indicative proposals" that as yet do not represent specific policies. Therefore, a detailed program-by-program evaluation of the President's revised budget is not possible now. Relying on the Administration's estimates of the proposed savings,

however, CBO has prepared a preliminary assessment of the budgetary effect of the President's new plan.

CBO estimates that the President's July budgetary plan would hold the total deficit to about $200 billion a year if the plan's assumptions were translated into specific policies (see Tables 1 and 2). For comparability with the budget resolution, CBO has adjusted its baseline deficit to reflect the projected effects on mandatory spending and revenues of rebenchmarking the consumer price index (CPI). In 1998, the weights of the various categories of consumption in the CPI will change from the current 1982-1984 basis to a 1993-1995 basis. The budget resolution adopted by the Congress assumes that this change will reduce the growth of the overall CPI by about 0.2 percentage points a year compared with CBO's winter economic assumptions.

Because of the different budgetary rules governing discretionary and mandatory programs, CBO has used different methods for estimating the savings in the two budgetary categories. For defense and nondefense discretionary spending, CBO's estimate assumes the level of outlays specified in the President's plan. The estimated discretionary savings equal the difference between the level of discretionary spending in CBO's baseline and that in the President's plan. Because CBO's baseline for those programs is higher than the Administration's baseline, CBO's estimates of the amounts of discretionary savings are larger than the Administration's savings figures. For mandatory spending programs and revenues,

TABLE 1. PRELIMINARY ASSESSMENT OF THE PRESIDENT'S BUDGETARY PROPOSALS (By fiscal year, in billions of dollars)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	1996-2002	1996-2005
CBO Baseline Deficit with Discretionary Inflation After 1998[a]	210	230	232	266	299	316	349	384	422	472	n.a.	n.a.
Adjustment for Rebenchmarking of the Consumer Price Index	0	0	0	-1	-3	-6	-10	-12	-14	-18	n.a.	n.a.
Adjusted Baseline Deficit	210	230	232	265	296	310	340	372	408	454	n.a.	n.a.
President's Budgetary Proposals[b]												
Discretionary spending	-7	-5	-12	-27	-39	-52	-67	-84	-101	-119	-208	-513
Mandatory spending												
Medicare	-3	-6	-9	-16	-23	-30	-38	-45	-54	-66	-124	-289
Medicaid	-4	-4	-6	-7	-9	-11	-13	-15	-17	-19	-54	-105
Welfare reform	-2	-4	-5	-5	-6	-6	-7	-7	-7	-8	-35	-57
Other	-6	-1	c	4	4	3	-2	-3	-3	-3	3	-6
Subtotal	-16	-15	-20	-24	-33	-44	-59	-70	-81	-96	-211	-457
Revenues[d,e]	3	10	11	14	19	20	21	21	21	23	98	163
Corporate subsidies[e]	-1	-2	-3	-4	-5	-5	-5	-6	-6	-6	-25	-43
Debt service[f]	-1	-2	-3	-5	-9	-14	-20	-30	-41	-55	-54	-179
Total Changes	-21	-13	-26	-46	-67	-94	-131	-168	-208	-253	-399	-1,029
Deficit Under the President's Budgetary Proposals	189	217	206	219	229	216	209	203	200	201	n.a.	n.a.

SOURCES: Congressional Budget Office; Office of Management and Budget, *Mid-Session Review of the 1996 Budget.*

NOTES: Numbers may not add to totals because of rounding. n.a. = not applicable.

a. Assumes compliance with discretionary spending limits through 1998. Discretionary spending is assumed to increase at the rate of inflation after that.

b. Discretionary savings equal the difference between CBO's baseline discretionary spending and the levels of discretionary spending specified in the *Mid-Session Review of the 1996 Budget*, released July 31, 1995. Mandatory spending savings and revenue changes are at the levels specified in the President's plan. CBO has not reestimated the savings because there is not sufficient detail available at this time to allow a reestimate.

c. Less than $500 million.

d. Excludes estimated loss of revenues from the Federal Reserve as a result of the Administration's anticipated reduction in interest rates.

e. Revenue losses are shown as positive because they increase the deficit.

f. Debt service represents CBO's estimate of the reduction in interest payments that would result directly from the noninterest savings shown in this table. It does not include any possible effect from lower interest rates that might result from lower deficits.

TABLE 2. PRELIMINARY ASSESSMENT OF BUDGETARY ESTIMATES UNDER THE PRESIDENT'S POLICIES (By fiscal year, in billions of dollars)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Outlays										
Discretionary										
Defense	262	257	255	260	268	276	281	282	282	283
Nondefense	283	292	290	289	288	287	288	292	297	301
Subtotal	545	549	545	549	556	563	569	573	579	584
Mandatory[a]										
Medicare[b]	175	192	207	222	238	257	277	303	330	358
Medicaid	96	106	116	128	139	152	165	179	195	213
Other	529	568	599	639	676	703	737	773	813	859
Subtotal	800	866	921	988	1,053	1,111	1,179	1,256	1,338	1,430
Net interest[c]	260	269	278	291	305	315	328	341	353	366
Total	1,605	1,684	1,744	1,828	1,914	1,990	2,077	2,170	2,270	2,380
Revenues[d]	1,416	1,467	1,538	1,609	1,685	1,774	1,868	1,967	2,070	2,179
Deficit Under the President's Budgetary Proposals	189	217	206	219	229	216	209	203	200	201
Deficit as a Percentage of GDP	2.6	2.8	2.5	2.6	2.5	2.3	2.1	1.9	1.8	1.7
Memorandum:										
Gross Domestic Product	7,370	7,747	8,152	8,572	9,013	9,483	9,978	10,499	11,047	11,623

SOURCES: Congressional Budget Office; Office of Management and Budget, *Mid-Session Review of the 1996 Budget.*

NOTES: Numbers may not add to totals because of rounding.

a. Projected mandatory spending is based on the Administration's estimates of savings from a current-policy baseline. CBO has not reestimated the savings because there is not sufficient detail available at this time to allow a reestimate.

b. Includes receipts from Medicare beneficiary premiums as offsets to Medicare spending.

c. Net interest projections are based on CBO's estimate of the reduction in interest payments that would result directly from the noninterest savings shown in this table. They do not include any possible effect from lower interest rates that might result from lower deficits.

d. Projected revenues are based on the Administration's estimates of changes from a current-policy baseline. CBO has not reestimated the changes because there is not sufficient detail available at this time to allow a reestimate. The projections exclude the estimated loss of revenues from the Federal Reserve associated with the Administration's anticipated reduction in interest rates.

CBO's preliminary assessment assumes that the net changes from the baseline equal those specified by the Administration. The revenue changes differ from those shown by the Administration because they exclude a reduction in Federal Reserve earnings resulting from the Administration's assumed drop in interest rates. CBO has estimated the resulting amount of savings in debt service using the interest rates that underlie its April baseline.

Under those assumptions, the budget deficit under the President's policies would represent about 2 percent of gross domestic product (GDP) in 2005. By contrast, CBO's baseline deficit averages more than 3 percent of GDP over the 1995-2005 period. The reduction in the deficit under the President's policies would allow a modest drop in interest rates compared with those in CBO's baseline. Because of the uncertainties surrounding the President's plan and the estimates of its effects on the budget, CBO has not incorporated a drop in interest rates attributable to deficit reduction. But even if some allowance was made for that effect, the deficits under the President's July budget would probably remain near $200 billion through 2005.

The deficits under the President's policies would be significantly higher in 1996 through 2002 than the deficits assumed by the budget resolution, reflecting substantial differences in the policies proposed by the two budget plans. The President proposes about $230 billion more in total discretionary spending over the seven-year period than the budget resolution assumes. In addition, CBO estimates

that mandatory spending under the President's proposals would be greater than such spending under the budget resolution's policies. The President proposes to reduce mandatory spending by $211 billion below the current-law projections for 1996 through 2002. By contrast, the budget resolution includes $626 billion in mandatory savings. The larger tax cut anticipated by the budget resolution would only partially offset those differences in discretionary and mandatory spending.

DIFFERENCES BETWEEN CBO AND OMB ESTIMATES

Compared with the deficit of $201 billion in 2005 that CBO estimates, the Administration projects that its policies would produce a budget surplus of $41 billion. What accounts for that difference of more than $240 billion between the two estimates?

First, in 2005 the Administration assumes about $55 billion in additional savings from lower interest rates--the so-called fiscal dividend. As previously indicated, CBO believes that the Administration's plan would produce a much smaller fiscal dividend than OMB anticipates because we estimate that the amount of deficit reduction falls short of that needed to achieve budgetary balance.

Second, CBO's projected baseline deficit is much higher than OMB's. CBO projects that the budget deficit under current policies will reach $454 billion in 2005, assuming that discretionary spending keeps pace with inflation after the discretionary spending limits expire in 1998. By contrast, OMB projects a baseline deficit of only $248 billion for 2005. Excluding differences in discretionary spending, CBO's projected baseline deficit exceeds OMB's by about $190 billion.

The baseline economic assumptions of CBO, with an adjustment for CPI rebenchmarking, underlie the budget resolution. These assumptions appear quite similar to those of the Administration (see Table 3). Nonetheless, the differences are sufficient to produce marked differences in budget projections that only grow with time. (CBO's summer economic forecast, which will be released later this month, will narrow the differences in 1995 and 1996, but CBO's longer-term economic projections will change very little.)

On average, the Administration foresees slightly faster economic growth than does CBO. Also, CBO and the Administration differ in their projections of the growth of the CPI relative to that of the GDP deflator. CBO assumes that the CPI will grow significantly faster than the deflator, whereas the Administration assumes only slightly faster growth. Because the CPI affects indexed benefit programs and tax brackets, whereas the GDP deflator affects estimates of taxable income, CBO's assumption of a larger gap between the two growth rates adds to its projection of the

TABLE 3. COMPARISON OF ECONOMIC ASSUMPTIONS, CALENDAR YEARS 1995-2005

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Nominal GDP (Billions of dollars)											
Budget resolution	7,127	7,456	7,847	8,256	8,680	9,128	9,604	10,106	10,633	11,188	11,772
Administration	7,091	7,470	7,879	8,310	8,765	9,245	9,745	10,268	10,819	11,400	12,011
Real GDP (Percentage change, fourth quarter over fourth quarter)[a]											
Budget resolution	2.5	1.9	2.4	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Administration	1.9	2.5	2.5	2.5	2.5	2.5	2.4	2.4	2.4	2.4	2.4
GDP Deflator (Percentage change, fourth quarter over fourth quarter)											
Budget resolution	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8
Administration	2.8	2.9	2.9	2.9	2.9	2.9	2.9	2.9	2.9	2.9	2.9
Consumer Price Index (Percentage change, fourth quarter over fourth quarter)[b]											
Budget resolution	3.2	3.4	3.4	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2
Administration	3.2	3.2	3.2	3.2	3.1	3.1	3.1	3.1	3.1	3.1	3.1
Civilian Unemployment Rate (Percent)											
Budget resolution	5.5	5.7	5.8	5.9	6.0	6.0	6.0	6.0	6.1	6.1	6.1
Administration	5.8	5.9	5.8	5.8	5.8	5.8	5.8	5.8	5.8	5.8	5.8
Three-Month Treasury Bill Rate (Percent)											
Budget resolution	6.2	5.7	5.3	5.1	5.1	5.1	5.1	5.1	5.1	5.1	5.1
Administration, without fiscal dividend	5.7	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5
Administration, with fiscal dividend[c]	5.7	5.4	5.2	5.0	4.8	4.6	4.6	4.4	4.4	4.4	4.4
Ten-Year Treasury Note Rate (Percent)											
Budget resolution	7.7	7.0	6.7	6.7	6.7	6.7	6.7	6.7	6.7	6.7	6.7
Administration, without fiscal dividend	6.6	6.8	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0
Administration, with fiscal dividend[c]	6.6	6.5	6.6	6.4	6.2	6.0	5.8	5.6	5.4	5.3	5.3

SOURCES: Congressional Budget Office, Office of Management and Budget.

a. Based on 1987 dollars

b. Consumer price index for all urban consumer (CPI-U). Compared with CBO's winter projections, the budget resolution reflects a 0.2 percent decrease in CPI growth resulting from rebenchmarking beginning in 1998.

c. Includes the reduction in interest rates assumed by the Administration to result from the deficit reduction it proposed in the *Mid-Session Review of the 1996 Budget*.

deficit. Largely as a result of differences in economic assumptions, CBO's projection of revenues in 2005 is $55 billion below the Administration's.

Estimating differences unrelated to economic differences also contribute to CBO's estimate of the baseline deficit compared with the Administration's estimates. In 2005, more than $50 billion of the difference in projected spending stems from differences in estimated outlays for Medicare and Medicaid. Although CBO believes that the growth of those programs will slow from the extremely high rates of recent years, it is not quite as optimistic as the Administration about the extent to which such a slowdown would occur without a change in policy.

Differences in estimates of other mandatory programs contribute $33 billion to the difference between CBO's and OMB's estimates of the baseline deficit. Finally, a $50 billion difference in projected net interest costs primarily reflects the debt service on the increase in the projected deficits that stems from CBO's other reestimates.

CONCLUSION

The Congressional Budget Office has long stressed the importance of bringing the federal deficit under control. Large federal deficits crowd out capital investment, raise interest rates, and restrict economic growth. If noninterest spending exceeds tax revenues, growing federal deficits will eventually lead to rapidly rising federal interest costs, unsustainable increases in the federal debt, and a reversal in the long-term trend of rising living standards.

The Administration's new budget proposal represents a significant step toward limiting the rise in federal deficits and debt. CBO estimates that if the plan's targets were met, the budget deficit would remain roughly constant in nominal terms and would decline in relation to the size of the economy. Although the plan would not produce a balanced budget, if carried out it would start to move federal fiscal policy off its present, unsustainable course.

The uncertainties involved in budget projections are legion, and small differences in estimating assumptions can lead to large differences in the projected deficit five or ten years in the future. Although the Administration's budget projections are somewhat more optimistic than those of CBO, they fall within the range of plausible outcomes. The 20-year history of Congressional budget

projections, however, suggests that the budget deficit is much more likely to exceed projections than to come in lower. It is CBO's view that erring on the side of caution increases the likelihood that a balanced budget will actually be achieved in the time desired.