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BUDGET ISSUES

Deficit Reduction and the Long Term

Statement of Paul L. Posner
Director, Budget Issues
Accounting and Information Management Division

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Mr. Chairman and Members of the Committee:

I appreciate the opportunity to appear before you today to discuss GAO's work on the deficit and the long-term economic health of our nation.

In 1992, we examined the role of fiscal policy in promoting or inhibiting long-term economic growth and concluded that deficit reduction was key to our nation's future economic health.[1] We noted then that long-term economic growth and the requisite investment are central to almost all our major concerns as a society. The surest way to increase the resources available for investment is to increase national savings, and the surest way to increase national savings is to reduce the federal deficit. We also noted that how the deficit is reduced matters. Last year, we updated this work for you and Chairman Domenici.[2]

By now, the relationship of the deficit to the nation's long-term interest has been more broadly recognized. Both the Congress and the President have proposed plans to reverse previous fiscal trends and balance the budget. It seems reasonable to conclude that the debate is no longer over whether to balance the budget, but rather over when and how.

In my testimony today, I will first describe GAO simulations of the economic impact of different fiscal policies over the long term and then address several issues related to the impact of deficit reduction specifically:

- the important and compelling benefits to be gained from successfully shifting to a new fiscal policy;
- the importance of how we reduce the deficit—by which I mean both the composition of federal spending and the need to deal with the drivers of the deficit; and
- the experience of other industrial nations.

Long-Term Simulations

Long-term simulations can be useful for comparing potential outcomes of alternative policies within a common economic framework. Given the broad range of uncertainty about future economic changes, however, any simulations should not be interpreted as forecasts of the level of economic

[1] Budget Policy: Prompt Action Necessary to Avert Long-Term Damage to the Economy (GAO/OCG-92-2, June 5, 1992).

[2] The Deficit and The Economy: An Update of Long-Term Simulations (GAO/AIMD/OCE-95-119, April 26, 1995).

activity 30 years in the future. Instead, simulation results provide illustrations of the budget or economic outcomes associated with alternative policy paths.

In our most recent work, we used a long-term economic growth model to simulate three of the many possible fiscal paths through the year 2025:

- a "no action" path that assumed the continuation of fiscal policies in effect at the end of fiscal year 1994;
- a "muddling through" path that assumed annual deficits of approximately 3 percent of gross domestic product (GDP); and
- a path that reaches balance in 2002 and sustains it.[3]

To suggest some of the trade-offs facing policymakers in choosing among fiscal policies, we examined some long-term economic and fiscal outcomes of these paths. We also simulated how some types of early action on the deficit, including early action on health care spending, might affect the long-term deficit outlook. Finally, we examined the prospects for sustaining balance over the long term. While we discuss the consequences of alternative fiscal paths, we do not suggest any particular course of action, since only the Congress can resolve the fundamental policy question of choosing the fiscal policy path and the composition of federal activity.

In our simulations we employed a model originally developed by economists at the Federal Reserve Bank of New York (FRBNY) that relates long-term GDP growth to economic and budget factors. Details of that model and its assumptions can be found in our reports.

The Compelling Case for Deficit Reduction

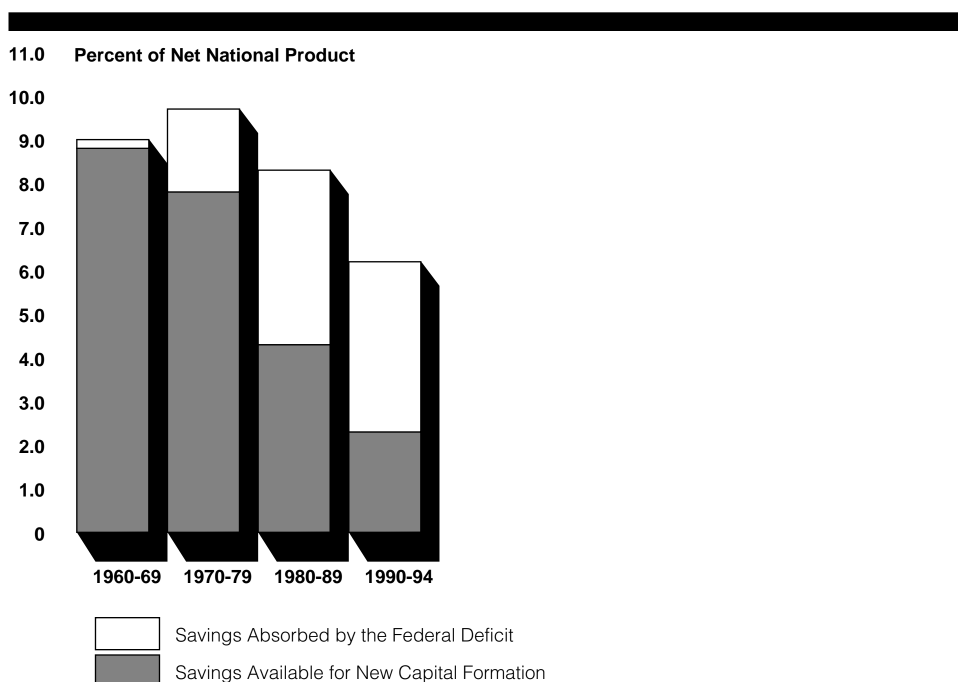
As we noted in 1992 and 1995, important and compelling benefits can be gained from shifting to a new fiscal policy path. As illustrated in figure 1, chronic deficits have consumed an increasing share of a declining national savings pool, leaving that much less for private investment.

Lower investment will ultimately show up in lower economic growth. Future generations of taxpayers will pay a steep price for this lower economic growth in terms of lower personal incomes and a generally

[3]The "balance" path takes unspecified cuts beginning in 1996 in all types of federal spending to achieve total deficit reduction of no more than 0.5 percent of GDP per year until balance is reached in 2002, after which balance is maintained in the same manner. The "muddling through" path follows Congressional Budget Office (CBO) deficit projections through 1999, then moves to a constant deficit of 3 percent of GDP by taking unspecified cuts.

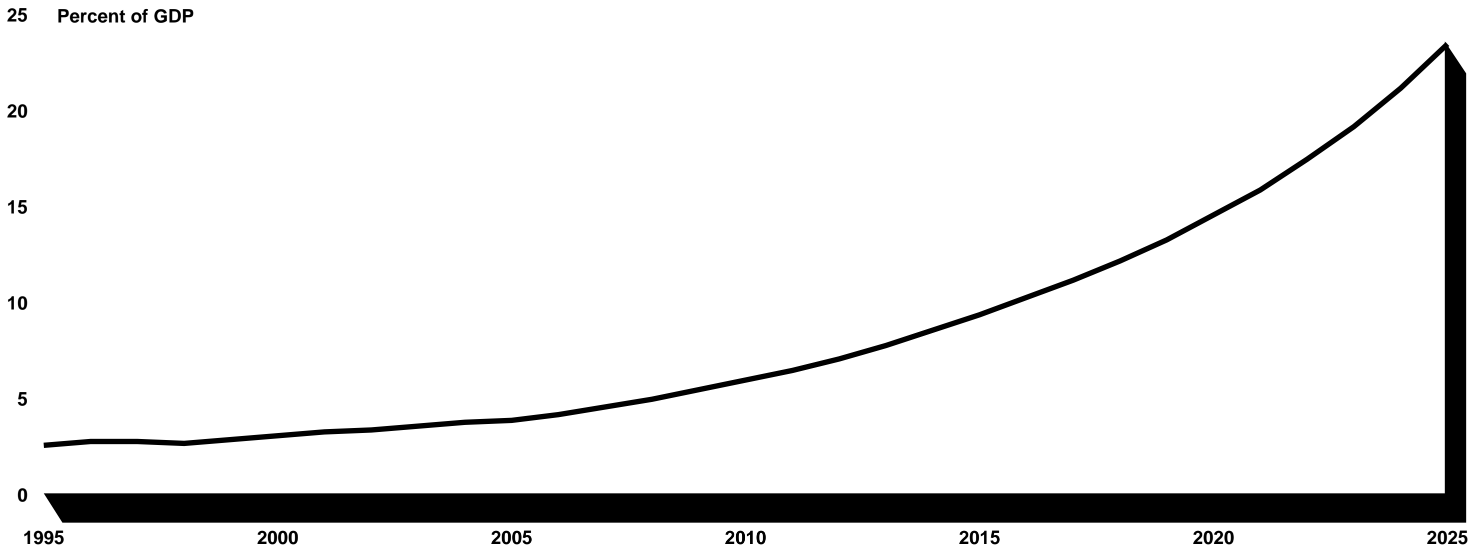
lower standard of living at a time when they will face the burden of supporting an unprecedented number of retirees as the baby boom generation reaches retirement.

Figure 1: Effect of the Federal Budget Deficit on Net National Savings
(1960-1994)



The problem has been that the damage done by deficits is long-term, gradual, and cumulative in nature and may not be as visible as the short-term costs involved in reducing deficits. This has presented, and continues to present, a difficult challenge for public leaders who must mount a compelling case for deficit reduction—and for the steps required to achieve it—that can capture public support. The updated simulations we presented to you and Chairman Domenici last spring confirmed that the nation's current fiscal policy path is unsustainable over the longer term. Specifically, a fiscal policy of "no action" on the deficit through 2025 implies federal spending of nearly 44 percent of GDP, and as figure 2 shows, a deficit over 23 percent of GDP.

Figure 2: Deficit Path in "No Action" Simulation (1995-2025)



Let me explain these ominous trends. The increased spending is principally a function of escalating federal spending on health care and Social Security, which is driven by projected rising health care costs and the aging of our population.[4] Spending on interest on our national debt also rises as annual deficits and accumulated public debt expand. Essentially, current commitments in these areas become progressively unaffordable for the nation over time. Without any significant changes in spending or revenues, such an expanding deficit would result in collapsing investment, declining capital stock, and, inevitably, a declining economy by 2025.

As emphasized in both our 1992 and 1995 reports, we do not believe that such a scenario would take place. Rather, we believe that the prospect of economic decline would prompt action before the end of our simulation period. Nevertheless, this "no action" scenario, by illustrating the future

[4]Budget assumptions rely upon the CBO January 1995 estimates through 2004 to the extent practicable. Beyond that, Social Security estimates were based on the April 1995 intermediate projections from the Social Security Trustees. Medicare projections were based on the Health Care Financing Administration (HCFA) long-term intermediate forecast from the Medicare Trustees' April 1995 report. For Medicaid, in the absence of HCFA projections, we used projections developed in 1994 by the Bipartisan Commission on Entitlement and Tax Reform.

logic of existing commitments, powerfully makes the case that we have no choice but to take action on the deficit. The questions that remain are when and how.

Our 1995 simulations also confirm the long-term economic and fiscal benefits of deficit reduction. We assessed the long-term impacts of balancing the budget by 2002, as was contemplated in the fiscal year 1996 budget resolution and in the recent executive-congressional discussions over budget policy, and of sustaining such a posture through 2025. We also estimated the effects of following a path that we called "muddling through"—that is, running deficit of about 3 percent of GDP over the next 30 years. Although current policy is better than this in the near term, it is still a useful illustration.

A fiscal policy of balance would yield a stronger economy in the long term than either a policy of no action or of muddling through. Table 1 shows that a budget balance reached in 2002 and sustained until 2025 would, over time, lead to increased investment, increased capital stock, a larger economy, and a much lower national debt than either of the other scenarios. This means that Americans could enjoy a higher standard of living than they might otherwise experience.

Table 1: The Economic and Fiscal Position in 1994 and in 2025

All dollar values in per capita 1995 dollars

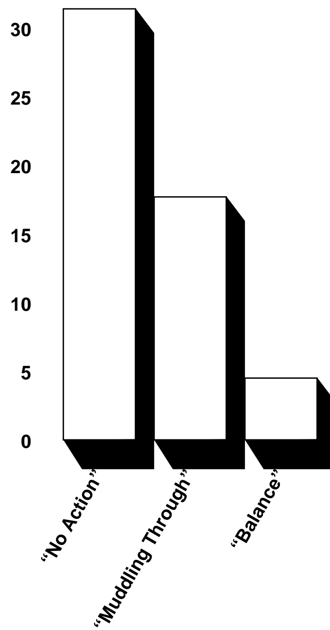
	1994	2025 No action	2025 Muddling through	2025 Balance	Percent difference between balance and no action	Percent difference between balance and muddling through
Real GDP	$26,300	$27,900	$35,100	$37,400	34	7
Debt	$13,500	$60,200	$21,400	$4,800	–92	–78
Debt as a percent of GDP	52	213	60	13	–94	–78
Nonfarm business investment	$3,100	$0	$4,200	$5,100	NA	21
Nonfarm capital stock	$23,700	$11,600	$30,100	$36,600	216	22

Reaching and sustaining balance would also shrink the share of federal spending required to pay interest costs, thereby reducing the long-term programmatic sacrifice necessary to attain deficit reduction targets. Even "muddling through" with deficits of 3 percent of GDP would exact a price through higher interest costs and thus require progressively harder fiscal choices as time progresses. Under the balance path, debt per capita would decline from $13,500 in 1994 to $4,800 in 1995 dollars by 2025; debt as a

percentage of the economy would drop from about 52 percent to 13 percent. Because of this shrinkage in the debt, by 2025 a balance path could bring interest costs down from about 12 percent in 1994 to less than 5 percent of our budget, compared to about 18 percent under "muddling through" and almost a third of our budget with no action. These differences are illustrated in figure 3.

Alarming as these model results may appear, they are probably understated. Our model incorporates conservative assumptions about the relationship between savings, investment and GDP growth that tend to understate the differences between the economic outcomes associated with alternative fiscal politicize. Furthermore, budget projections for the near term and those assumed in our long-term model results may not tell the whole story. By convention, baseline budget projections do not include all the legitimate claims that may be made on the budget in the future. Rather, budget projections ignore many future claims and the costs of unmet needs unless they are the subject of policy proposals in the budget. Examples of such claims and needs would include the cost of cleaning up and restructuring the Department of Energy's (DOE) nuclear weapons production complex, the cost of hazardous waste pollution clean-up at military facilities, and cost overruns in weapons systems. In short, most of the risks to future budgets seem to be on the side of worse-than-expected, rather than better-than-expected outcomes. I make this observation not to create despair but to underline the need to continue efforts at deficit reduction.

Figure 3: Net Interest as a Share of Total Expenditures in 2025 Under GAO's Three Fiscal Policy Simulations



The Type of Spending Reduction Matters

Not all spending cuts have the same impact over the long run. Decisions about how to reduce the deficit will reflect—among other considerations—judgments about the role of the federal government and the effectiveness of individual programs. I would like to call attention today to two significant considerations in deficit reduction: (1) the importance of federal investment in infrastructure, human capital, and research and development (R&D), and (2) the importance of addressing the fast-growing programs in the budget.

Composition of Federal Spending: Investment

In our 1992 work, we drew particular attention to the importance of well-chosen federal investment in infrastructure, human capital, and R&D. A higher level of national savings is essential to the achievement of a higher rate of economic growth but, by itself, is not sufficient to assure that result. Certain other ingredients are necessary—including the basic stability with which this nation has been blessed in its social, political, and economic environment. In addition, however, economic growth depends on an efficient public infrastructure, an educated work force, an expanding base of knowledge, and a continuing infusion of innovations.

In the past, the federal government, through its investments in these areas, has played an important role in providing an environment conducive to growth. Thus the composition of federal spending, as well as overall fiscal policy, can affect long-term economic growth in significant ways.[5]

Dealing With the Deficit Drivers

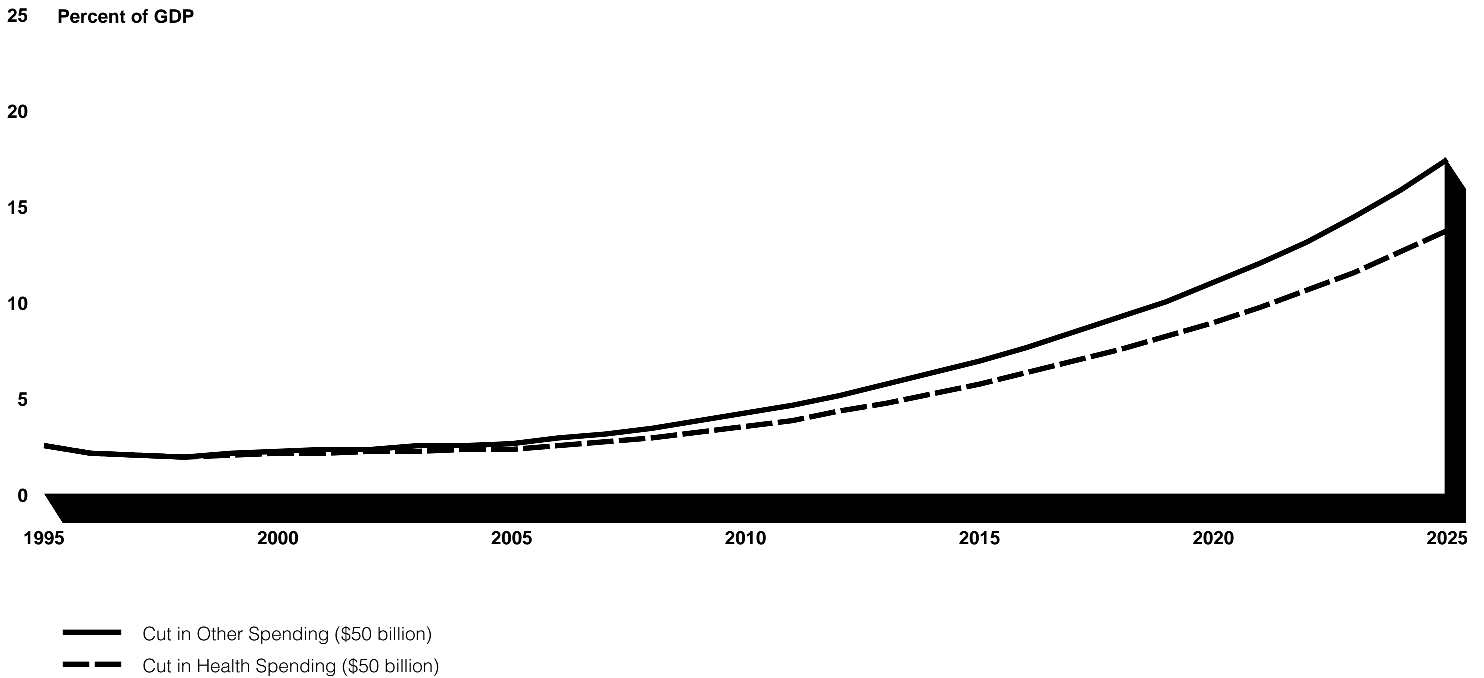
The extent to which deficit reduction affects spending on fast-growing programs also matters. Although a dollar is a dollar in the first year it is cut—regardless of what programmatic changes it represents—cutbacks in the base of fast-growing programs generate greater savings in the future than those in slower-growing programs, assuming the specific cuts are not offset by increases in the growth rates of the programs.[6]

Figure 4 illustrates this point by comparing the long-run effects of a $50 billion cut in health spending with those of the same dollar amount cut from unspecified other programs. For both paths the cut occurs in 1996 and is assumed to be permanent but, after 1996, spending is assumed to continue at the same rates of growth as those shown in the "no action" simulation. We used the simple assumption that a reduction in either health or other programs would not alter the expected growth rates simply to illustrate the point that a cut in high-growth areas of spending will have a greater fiscal effect in the future than the same size cut in low-growth areas. A $50 billion cut in health spending in 1996 leads to a deficit in 2025 that is about 4 percent of GDP lower than would be the case from a $50 billion cut in a low-growth program.

[5]See also Federal Budget: Choosing Public Investment Programs (GAO/AIMD-93-25, July 23, 1993) and Budget Issues: Incorporating an Investment Component in the Federal Budget (GAO/AIMD-94-40, November 9, 1993).

[6]We did not simulate the effect of reducing growth rates. If cutting the base also had the effect of slowing the rate of growth, the action would have an even greater impact on the long-term deficit. Of course, if cutting the base raised the growth rate, the actions could raise the deficit in the long term.

Figure 4: Comparison of Deficit Path With an Early Cut in Health to Deficit Path With an Equal Cut in Other Spending



Further, our simulations show that even if a balanced budget is achieved early in the next century, deficits would reappear if we fail to contain future growth in health, interest, and social security costs.

The Experience of Other Industrial Democracies

We conclude from these simulations that how and when deficit reduction occurs can have important long-term implications for the future economy and future budgets. As noted earlier, the benefits of deficit reduction in the long run may not seem as compelling as the short-term costs necessary to reduce the deficit. Nevertheless our work on the deficit reduction experiences in other nations[7] shows that significant fiscal improvement is indeed possible in modern democracies, at least for a time.

To reach fiscal balance or surplus, the governments we studied instituted often painful measures while generating and maintaining political support.

[7]Countries studied were Australia, Canada, Germany, Japan, Mexico, and the United Kingdom. See Deficit Reduction: Experiences of Other Nations (GAO/AIMD-95-30, December 13, 1994).

Spending control proved the dominant policy tool used to achieve fiscal goals, although few programs were actually eliminated. Notably, however, several countries restrained social benefit commitments in their quest for savings. Government leaders sought to gain support or at least defuse potential opposition by bringing key interest groups that would be affected into the decision-making process.

In addition, the design of the specific deficit-reducing strategies helped. Approaches such as reducing benefits instead of eliminating programs, targeting benefit cuts to higher-income beneficiaries, and deferring or shifting painful adjustments all helped maintain political support for spending reductions.

The deficit reduction brought about in these governments provided significant fiscal benefits by slowing or reversing the growth of public debt, thereby slowing or reversing the growth of government interest costs. As we simulated in our long-term growth model, what was once a "vicious" circle of rising deficits, debt, and interest, which can in turn increase deficits, became a "virtuous" circle of falling deficits or rising surpluses, accrued even though most governments we studied did not sustain fiscal balance or surplus, possibly in part because public support for austerity was frequently linked to relatively short-run concerns. Despite this return to deficit, the increases in savings and investment resulting from deficit reduction may have boosted economic prospects for the long-term future, as well as provided fiscal benefits in the short run.

Conclusion

Although the experiences of the nations in GAO's study suggest that resolving deficits is possible in advanced democracies, they also indicate that sustaining fiscal discipline over the longer term is difficult. Thus, deficit reduction strategies designed to promote long-term fiscal progress may help ensure that future budgets are better positioned to withstand future economic and political pressures.

For the United States, reaching budgetary balance in 2002 would indeed represent an achievement that by itself would bring about fiscal and economic benefits. Yet this achievement will not eliminate the need for future fiscal discipline. In fact, the needs of an aging society will be more easily met if fiscal balance—or even surplus—is both achieved and sustained for several years.

In conclusion, Mr. Chairman, I would repeat our view that current policy is unsustainable. The question, therefore, is not whether to reduce the deficit but when and how. We believe those choices matter.

Mr. Chairman, this concludes my written statement. I would be happy to answer any questions you or your colleagues might have.

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