United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Deficits, Debt Management and International Debt
Committee on Finance
United States Senate

or Release on Delivery
xpected at
):00 a.m., EDT
iday
ne 5, 1992

BUDGET POLICY

Long-Term Implications of the Deficit

Statement of
Charles A. Bowsher
Comptroller General of the United States

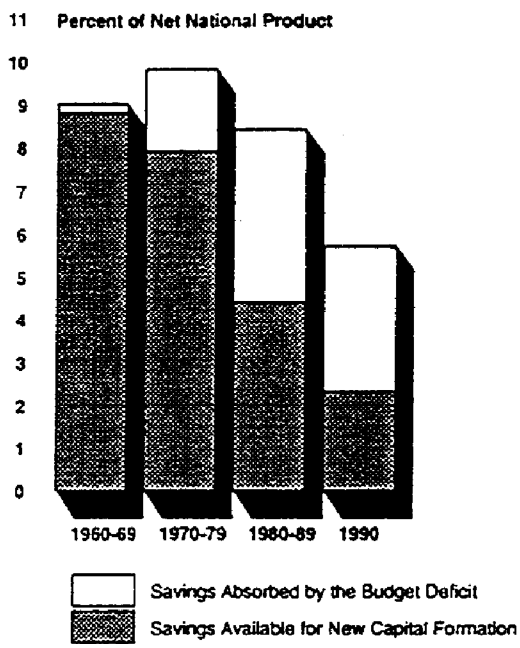
O/T-OCG-92-4

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to appear today to discuss the importance of deficit reduction and better budgetary decisions to our long-term economic health. The report[1] we are issuing today presents an urgent double message: we must put our fiscal house in order, and we must shift our federal spending priorities away from consumption and toward investment.

Deficits, by themselves, do not create crises, but they do quietly erode the savings needed for private investment and future economic growth. As figure 1 shows, the rising deficit in the 1980s and early 1990s coincided with a sharp drop in the net national savings available for investment. The share of national savings absorbed by the deficit grew from 2 percent in the 1960s to 58 percent in 1990. Only an influx of foreign capital sustained investment. Unfortunately this reliance on foreign investment has its price because future profits and interest payments will flow abroad. There is much we do not yet know about increasing investment and productivity. It is clear, however, that increasing national savings by reducing the deficit will promote greater investment and long-term economic growth.

ure 1: Effect of the Federal Budget
icit on Net National Savings
60-1990)



Source: Economic Report of the President, February 1992

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

Using deficits to finance a high level of spending on public investment programs could mitigate the dampening effects of deficits on economic growth. However, pressures created by deficits and the accompanying growth in spending on mandatory programs and interest on the debt have caused a reduction in the share of the budget spent on infrastructure, research and human capital programs vital to long-term economic growth.

INACTION IS NOT A SUSTAINABLE POLICY IN THE FACE OF WIDENING DEFICITS

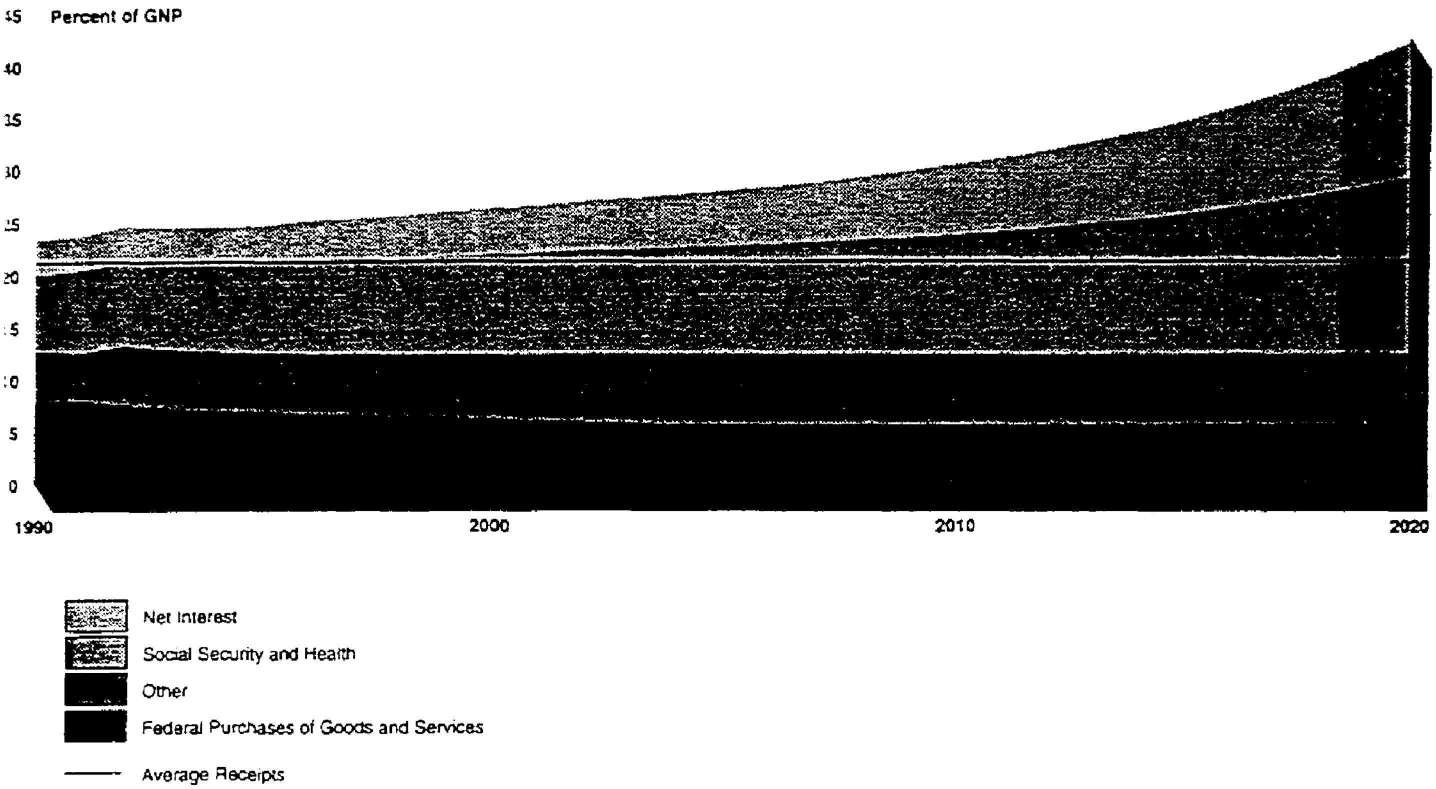
In the short-term, the costs of reducing the deficit may seem greater than the benefits of doing so. In addition, the task must sometimes seem hopeless. Despite the various deficit reduction acts and budget summits of the past 7 years, the deficit has grown. In the 1970s, deficits averaged just over 2 percent of gross national product (GNP). Under Congressional Budget Office (CBO) projections, the average cash basis deficit for the decade of the 1990s will be 4 percent of GNP, the same as the 1980s. This assumes compliance with the Budget Enforcement Act (BEA) and that discretionary programs grow no more rapidly than inflation after BEA expires in 1995.

As frustrating as this seems, we cannot walk away from the problem. It will only get worse and much harder to deal with over the long run. In the unlikely event that we continue our current spending and tax policies, our projections show deficits exploding to 20 percent of GNP by 2020. This is not sustainable. If we do not act on our own initiative, external economic events will force us to act. For example, the withdrawal of foreign investment would bring escalating interest rates or accelerating inflation, or both, and ultimately force painful adjustments. Thus, the key question facing policymakers is not whether to reduce the deficit, only when and how.

Although it is unlikely that this projection could come to pass, the individual assumptions underlying it are, in fact, conservative. To produce the numbers characterizing this scenario and others, we adapted an economic growth model developed by economists at the Federal Reserve Bank of New York. The expanded model allowed us to explore the long-term effects of different fiscal policies. In particular, the model captures the vicious circle linking the deficit, interest costs, and the national savings rate. This year's deficit not only reduces this year's national saving rate, it also increases interest costs and deficits in future years, further depressing saving and economic growth. This model, and our assumptions, are described in the report we are issuing today.

Figure 2 shows the forces driving the long-term explosion of federal spending if current policies continue: retirement costs, health spending, and interest payments. We called this course the "no action scenario." Beginning around the year 2010, the nation will undergo a major demographic shift. The baby boom generation will enter retirement at a time of increased life expectancy. Not only will the number of elderly increase, but the number of very old will increase. Moreover, the ratio of workers to retirees will decline from today's 3.4-to-1 to 2.4-to-1 in 2020.

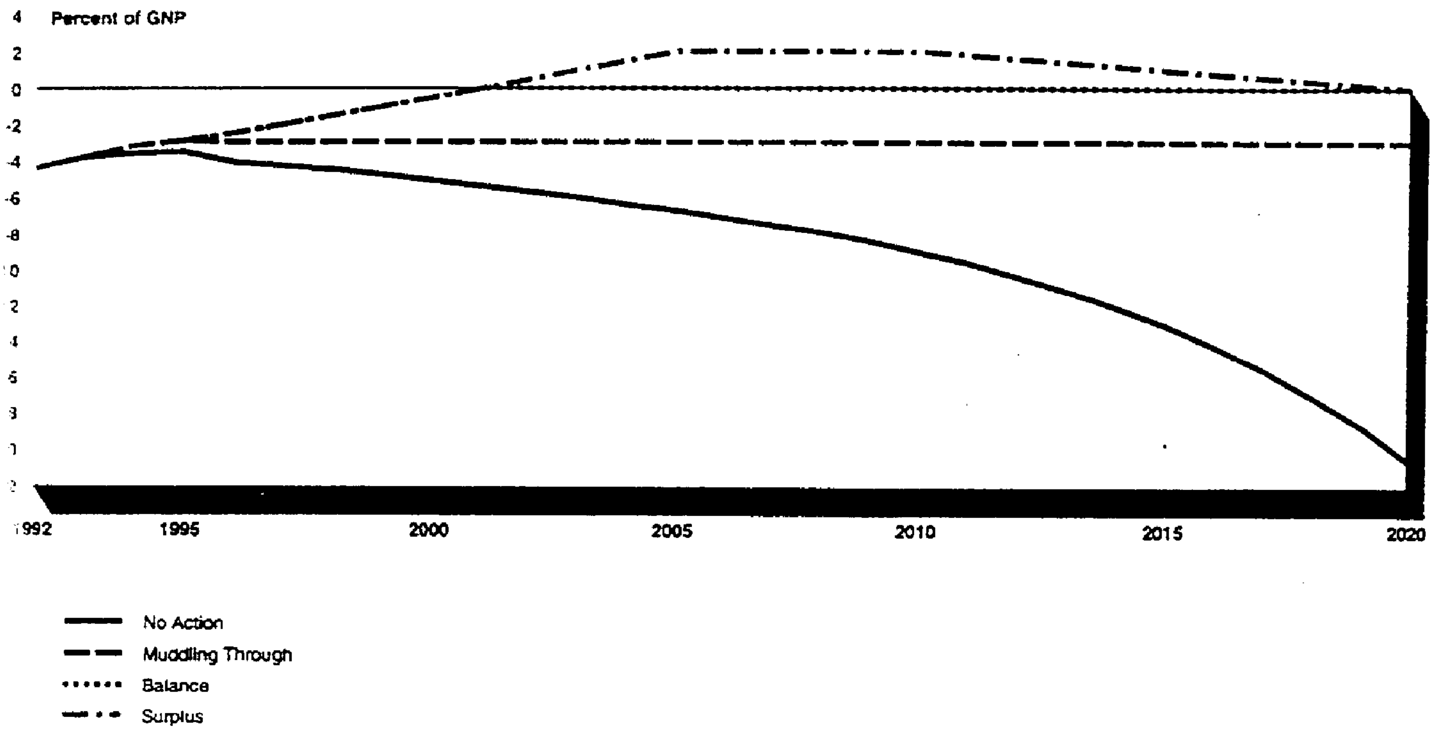
Figure 2: Federal Expenditures in the No Action Scenario



These demographic trends have profound implications for the budget. The annual Social Security surpluses will begin declining around 2010, with outlays projected to exceed revenues by 2017 unless adjustments are made to revenues or benefits in the meantime. The aging of the population will fuel the already rapid growth in health care costs. Data from the Department of Health and Human Services indicate that Medicare and Medicaid outlays alone will grow from 2.8 percent of GNP in 1990 to about 7 percent by 2020. The burgeoning interest costs that inevitably accompany persistently high deficits will grow to consume over 30 percent of federal spending.

Recognizing that the path of "no action" is unsustainable, we examined three alternative approaches to deal with the deficit, which are illustrated in figure 3. We called the first alternative "muddling through" since we assumed that somehow the deficit would be held to 3 percent of GNP. We compared this to (1) a path where budget balance is achieved in 2001 and maintained and (2) a surplus scenario where a 2 percent budget surplus is reached in 2005, maintained until 2010, and then phased down to balance by 2020.

Figure 3: Alternate Deficit/Surplus Paths (1992-2020)



THE ADVANTAGES OF PROMPT ACTION

A close examination of the results of the muddling through option shows the advantages of taking the early and major deficit reduction implied by either balance or surplus paths. Although muddling through requires less pain initially, maintaining a deficit of 3 percent of GNP grows progressively more difficult. We have to reduce the 2020 deficit alone by over half a trillion 1992 dollars to hold the deficit to 3 percent of GNP. This scenario would continue the government's preoccupation with deficits well into the next century, while perpetuating the current policy paralysis as well.

Moreover, failure to deal decisively with the deficit early on leads to a dramatic growth in interest costs--already the fastest growing component of federal spending. Over the last decade, we have seen how compound interest adds to the damage of a growing deficit as interest to finance the debt in turn adds to the amount of debt that must be financed.

Under the muddling through option, this phenomenon continues, as interest costs reach nearly $400 billion in 1992 dollars by 2020. Early and major deficit reduction, on the other hand, turns compound interest into a boon. Early cuts reduce debt service costs, thereby reducing the amount of deficit reduction that must come from real program reductions or revenue increases. The sooner we act, the more interest we save.

Demographics also argue for early action. Achieving a more robust economy by 2010 will help the relatively smaller working population shoulder the increased Social Security burden without reducing their future living standards. It will take time, however, for actions reducing the deficit to produce higher levels of investment and more rapid growth. If we wait until after the demographic shift begins and retirement costs start to escalate, the economic growth dividend may not come in time to help the next generation. We need to act early to ensure that the surpluses built up in the Social Security trust fund can actually be used to promote economic growth before they are dissipated by the program's future spending needs.

In addition, early action broadens the range of substantive policy options available. A short-term perspective leads to a search for "fast hits"--changes that yield quick savings. A long-term perspective allows for gradual changes and for the effects of early changes to multiply. It allows some changes to be phased in over time, permitting society to adjust and plan for the consequences. Often, a sensible path for policy changes shows small savings in early years but larger savings in later years.

The problem of health care cost containment provides a vivid example of this phenomenon. The preoccupation with each year's budget in isolation forces us into a hectic search for ways to save a few million dollars, often by fruitless attempts to shift costs to others. A longer time frame would encourage consideration of more fundamental issues regarding the way we deliver and finance health care, issues having profound implications for the economy as a whole as well as the federal budget for decades to come.

Of course, moving from our current fiscal policy path to either the balance or surplus path will require sacrifice. The real question is, are the benefits achieved worth the pain? One way to answer that question is to assess the kind of legacy each alternative path leaves for the economy in the long-term and for succeeding generations.

Adopting either a balance or surplus path would provide the greatest benefit to the long-term health of the economy. As shown in table 1, real GNP would grow significantly while both foreign debt and public debt shrink toward zero. Major gains in economic output would be achieved under either scenario, while a greater share of domestic investment would be financed by domestic sources.

Table 1: Results of Alternative Deficit Paths for 2020 (Per capita 1992 dollars)

Deficit Paths	Real GNP	Foreign Debt	Debt Held By the Public
No action	$23,875	$19,243	$45,816
Muddling through	$30,374	$ 8,460	$16,702
Balance	$32,555	$ 3,748	$ 4,665
Surplus	$33,353	$ 1,979	$ 219

The gains associated with deficit reduction do not, of course, come for free. The hard choices needed to achieve a balance or surplus would temporarily reduce consumption as savings are increased. In the long term, however, the higher national saving rate brought about by deficit reduction would raise consumption significantly beyond levels that could otherwise have been achieved. Again, early deficit reduction would help ensure that the temporary reduction in consumption is spread over the larger current working population. The earlier we begin this effort, the greater assurances we have that economic benefits can be realized by the next generation of workers.

This shift in fiscal policy is long overdue, but simply making more resources available for private investment will not be enough. In a competitive world economy, we need to make this nation an attractive place to invest. Public policies encouraging the development of human capital, infrastructure, and research will help retain this country's status as a productive platform for economic growth and development. In this regard, it is particularly disturbing that federal programs oriented toward investment actually lost ground in the 1980s, surpassed as a share of GNP by federal interest payments and health care spending.

MAJOR BUDGET POLICY DECISIONS NEEDED

The task we face is large, but not impossible. Other nations, including Germany, Japan, Australia, and the United Kingdom, have moved from large deficits to near balance or surplus in the 1980s. However, we should not pretend that we can reach either of these paths without fundamental policy changes. I bow to no one in my commitment to and concern for efficient management, good financial controls, and accountability in government programs. We cannot afford to waste any of our scarce resources. And we cannot afford the erosion of public trust in government that inevitably follows the loss of accountability for public funds. But strengthened accountability and more efficient management and implementation of current programs, while vital objectives in their own right, cannot save enough money by themselves to solve our deficit problem.

Moreover, the amount of deficit reduction needed to achieve either balance or a surplus will be difficult, if not impossible, to achieve if any major areas of spending or potential revenues are set "off the table." The very magnitude of the changes needed should prompt a major debate over the role of the federal government and how to pay for it. Facing these issues openly will be painful, but the issues will not go away.

To achieve the necessary deficit reduction, decisionmakers must look at large and/or growing areas of the budget. I believe that every effort should be made first to reduce spending in these major categories. If a national debate on the federal role and spending priorities fails to identify sufficient savings to close the deficit, revenues could then be addressed as part of the deficit reduction strategy.

Mandatory spending is a logical category for examination because it has grown to be the largest sector of federal spending. Within that category, spending on health care--which is large and rising rapidly-is a particular candidate for review. In this area, we must find ways to reduce underlying costs and the pressures increasing those costs. It is increasingly apparent that we cannot solve the problem by tinkering at the margin and shifting costs to others.

Sooner or later, the Social Security program must be adjusted, not only because it has such a large effect on the budget, but also because its projected annual outlays will exceed revenues by 2017. At that point, Social Security will be adding to the total deficit rather than offsetting it, as is the case today. Defense spending is another very large component of federal spending and, hence, must be included in all deliberations. It could become a candidate for additional reductions as the nation continues to define its changing role in the world.

Although domestic discretionary spending took large budgetary hits in the 1980s, it should not be exempt from scrutiny. A fundamental rethinking of the respective roles of federal, state, and local governments as well as the private sector might very well lead to reductions in this category of spending. However, since most federal investment activities are in domestic discretionary programs, some portion of the savings might be devoted to increased investment.

STRUCTURAL CHANGES IN THE BUDGET PROCESS

The available tax and spending choices that could move the budget toward balance or surplus are already well known and could be made under existing rules and practices. However, current practices place too little emphasis on the future effects of either aggregate fiscal policy or the composition of spending. A budget structure and a process that explicitly links current decisions to their impact on long-term economic growth would help focus the debate on these choices. The significant but short-term sacrifices of deficit reduction could be more easily compared to the long-term benefits accruing from such changes in budget policy.

There may be understandable skepticism about any proposal for a longer time frame. However, making and keeping commitments to long-term goals are not alien to American society. The interstate highway system, which took a generation to complete, and the Social Security system, with a 75-year planning horizon, are two prominent examples.

Any process that promotes a long-term focus would also direct attention to how the components of federal spending affect long-term productivity and growth. Although federal programs vary considerably in their impacts on the economy, the present budget process and structure do not encourage decisionmakers to take these differences into account in allocating resources.

Further, there is no framework to consider the investment implications of federal tax policy subsidies, such as depreciation rules or the research and experimentation tax credit, when making decisions on related spending programs. If planning for long-term economic growth is to become a central objective of the budget process, a new decision-making framework is needed--one in which the choice between consumption and investment spending is highlighted throughout the decision process rather than being displayed for information purposes after the fact.

If such a framework were in place, the Congress, each year, could determine explicitly the aggregate funding for total investment-related programs, as well as for the physical capital, human capital and research and development components of that total. To support such a decision process focusing on investment choices, improvements would be needed in the tools and information used to evaluate the relative impacts or rates of return of the various federal investment programs, to ensure that limited federal resources are used to promote the best choices among competing strategies and programs.

Having endorsed these changes in our budget process, let me hasten to add that there is no substitute for making the tough choices needed to set the nation on a productive path for future growth. We need to undertake the painful but necessary process of educating the American people on the choices and the consequences of failing to make them.

Ordering Information

The first copy of each GAO report and testimony is free. Additional copies are $2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

U.S. General Accounting Office
P.O. Box 6015
Gaithersburg, MD 20877

Orders may also be placed by calling (202)275-6241.

United States
General Accounting Office
Washington, D.C. 20548

Official Business
Penalty for Private Use $300

First-Class Mail
Postage & Fees Paid
GAO
Permit No. G100