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**BUDGET POLICY**

**The Budget Deficit and  
Long-Term Economic Growth**

Statement of  
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Mr. Chairman and Members of the Committee:

I appreciate having this opportunity to participate in your hearing on improving long-term decision making in government. As you know, the topic is one that has been of continuing interest and concern to the GAO. Just last week, we released a major new report<sup>1</sup> on budget policy that was prepared at the request of Senators Bradley and Domenici, a request subsequently joined by Senator Sasser and by Representatives Panetta and Hamilton. The report takes a long-term view of the deficit problem and of federal spending priorities. It also identifies areas where better information, presented in more informative ways, may help the Congress to grapple more effectively with the substantive issues.

In my remarks today, I will draw heavily on our new report, focusing primarily on our analysis of the long-term economic consequences of the budget deficit and the benefits that deficit reduction would bring to the economy. I will also address briefly the steps that might be taken to shift federal spending priorities toward investment -- a shift that we believe is badly needed.

#### BACKDROP: THE NO ACTION SCENARIO

When we began work on this report, one major purpose was to examine the budget deficit as a factor affecting the long-term

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

health of the economy. There is, of course, a broad consensus that the deficit is dangerous to our economic health because it absorbs national savings. 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 net national savings absorbed by the deficit grew from 2 percent in the 1960s to 58 percent in 1990. In earlier work<sup>2</sup>, we set forth the reasoning that links the deficit to the saving rate and hence to economic growth, identified several packages of options for deficit reduction, and analyzed the short and medium-term implications of deficit reduction for the economy. Our new effort included a more systematic look at the deficit's long-term implications for economic growth. In particular, we wanted to explore the relationship between the deficit problem and the demographic transition that will occur about 2010, as the baby boom generation begins to retire.

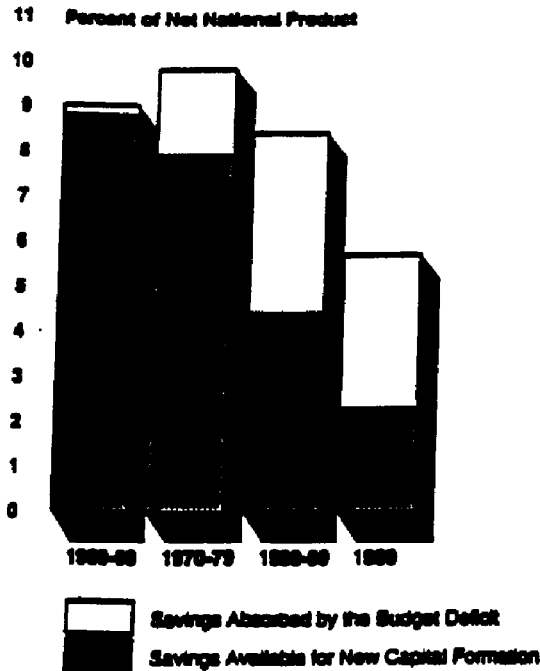
Only when our work was well advanced did we fully realize that our subject, the deficit problem, would itself be transformed in the decades ahead into something quite different from the all-too-familiar deficit problem of the past. The projected levels of the deficit and the national debt for the next few years are important, but become even more so when regarded as the critical starting point for a new and more

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<sup>2</sup> The Budget Deficit: Outlook, Implications and Choices (GAO/OCG-90-5, September 12, 1990), and the companion report Budget Deficit: Appendixes on Outlook, Implications, and Choices (GAO/OCG, September 28, 1990).

dangerous deficit dynamic. The principal drivers of this new dynamic are expenditures for health care, interest, and (particularly after 2010) Social Security.

Figure 1: Effect of the Federal Budget Deficit on Net National Savings (1960-1990)



Source: Economic Report of the President, February 1992

As input to our own economic projections, we used projections of expenditures for Medicare, Medicaid and Social Security prepared by actuaries at the Health Care Financing Administration (HCFA) and the Social Security Administration (SSA). Expressed as percentages of GNP and added together, these show an increase of over five percentage points over the period 1992-2020, or about one percentage point every five and a half years. By itself, of course, this has no implications for the budget deficit. If something is done about it, this expenditure increase need not increase the deficit at all. A period of almost three decades should provide ample occasion to do

something about it. In considering what "doing something about it" would involve, however, it is sobering to consider five percentage points of GNP from various perspectives, for example:

- It is only slightly less than we now spend on defense.
- It is about the size of the deficit for this fiscal year.
- It is five times as large as the total federal non-defense payroll, which in recent years has been very close to 1 percent of GNP.

An alternative version of this last perspective: if the non-defense federal payroll were somehow eliminated entirely, the emerging budgetary challenge of Social Security and health expenditures would be successfully addressed for 1.4 presidential terms, and then the problem would have to be addressed again.

If there are no changes in these three major entitlement programs or major policy adjustments affecting receipts or other spending, the deficit will necessarily increase. Expenditures for net interest on the national debt already absorb about one dollar in seven of federal expenditure; they will rise further as the deficit and the debt increase.

The "no action" scenario in our report links this budgetary outlook to the prospects for economic growth. It assumes that the change in the federal deficit is the principal driver of the national saving rate. Saving from non-federal sources -- individuals, businesses and state and local governments -- is assumed to be a constant 16.5 percent of GNP. Total national

saving is non-federal saving plus federal saving -- or, in this case, dissaving in the form of the budget deficit.

To explore the implications of these assumptions, and other discussed subsequently, we used an economic model adapted from one developed by economists at the Federal Reserve Bank of New York. In the model -- and we believe in reality -- a lower saving rate means a lower rate of investment in plant and equipment and other forms of physical capital. Lower investment is reflected in lower output in subsequent years. The model thus provides a picture of the vicious circle linking the deficit, interest costs and the national saving 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. The model and its underlying assumptions are described in our recent report.

Figure 2 shows what the "no action" scenario implies in terms of the behavior of federal expenditures in relation to GNP.

We have projected federal expenditures other than Social Security, health and net interest at a constant share of 12.3 percent of GNP, down slightly from recent levels. Federal receipts are a roughly constant share of GNP at around 21 percent of GNP. When Social Security, health and net interest costs are factored in, the result is that expenditures explode to over 40 percent of GNP in 2020, and the deficit to over 20 percent. This dismaying picture reflects all elements of the vicious circle described above. It is not just that Social Security and health

care expenditures rise, but that interest costs magnify the effect. And it is not just that the deficit increases, but that economic growth declines as a result. In fact, at the end of the "no action" projection, GNP is actually declining.

Figure 2: Federal Expenditures in the No Action Scenario



We do not believe that the no action scenario depicts a plausible policy path. There are, however, at least two distinct reasons why this projection might be implausible. The first reason is that it assumes an extreme policy passivity as the deficit burgeons out of control. Although the temptations of

procrastination on the deficit problem are strong, it is hard to credit the notion that such extreme passivity would prevail for such an extended period. The second reason is much less cheerful. If the nation were to proceed down such a path for another decade or more, then it is quite likely that our no action projection errs on the side of optimism. A number of the assumptions underlying the projection are conservative in the sense that they neglect economic mechanisms that could produce worse trouble, and sooner. The dismaying picture shown for 2020 may never happen, because even more severe stresses would emerge at an earlier date.

In short, the no action projection makes a compelling case that major policy action must be taken. The question is when and how much.

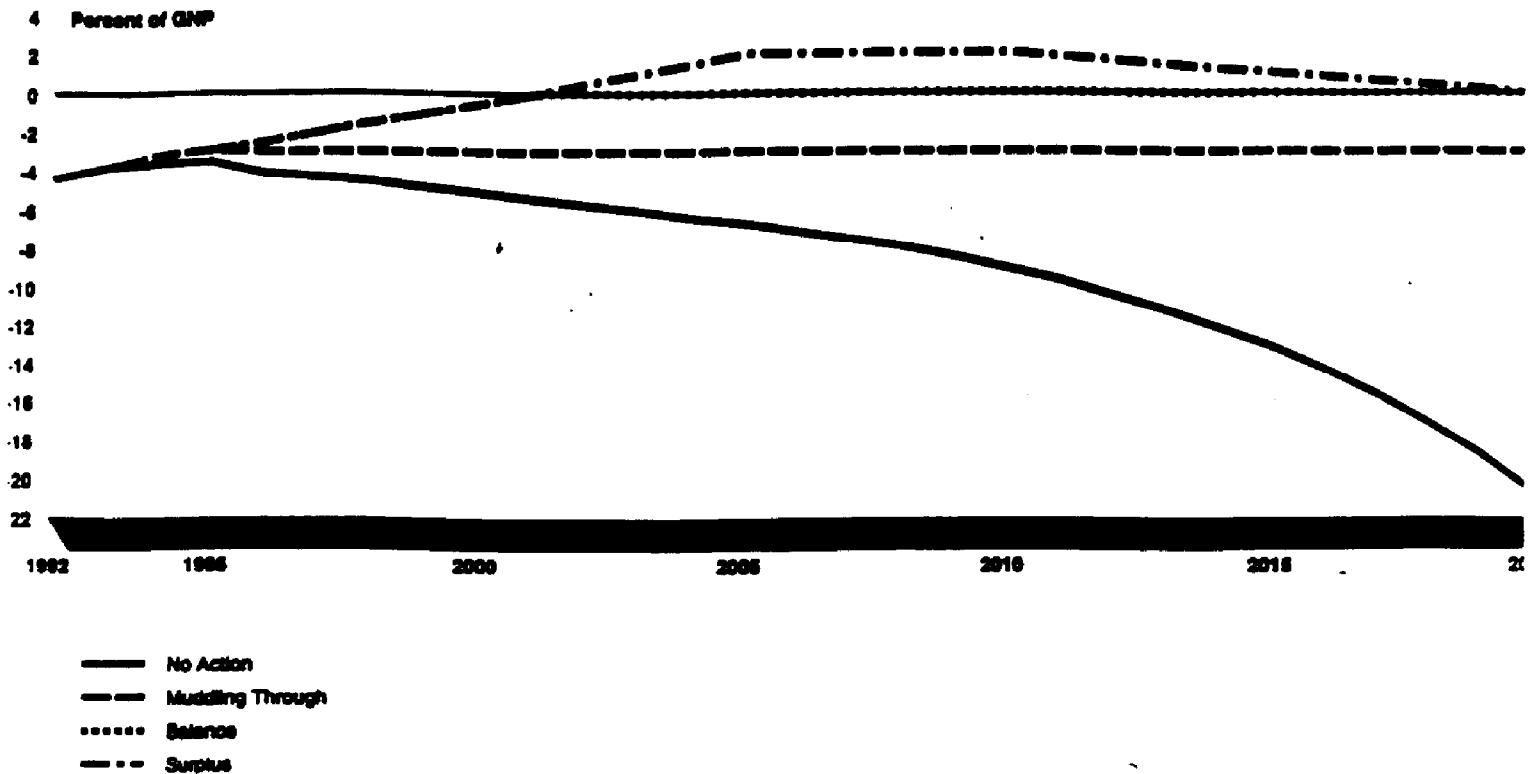
#### ALTERNATIVE FISCAL PATHS

Recognizing that the path of "no action" is unsustainable, we examined three alternative approaches to deal with the deficit. Each of these projections involves a particular assumed path for the deficit. The national debt, and with it net interest costs, are assumed to develop according to the assumed deficit path. We identified the magnitude of the policy adjustments required to achieve these paths but not the specific changes in spending and revenues that might be adopted to reach the result.



The first alternative we called "muddling through" because it involves continuing efforts to control the deficit, but no discrete and decisive action. Under "muddling through" the deficit is held at 3 percent of GNP after 1995. We compared this to (1) a path where budget balance is achieved in 2001 and then maintained, and (2) a surplus scenario where a 2 percent budget surplus is reached in 2005, maintained until 2010, and then phased back down to balance in 2020. This last assumption was motivated in part by recognition that the demographic transition beginning about 2010 will itself put downward pressure on living standards, making a higher national saving rate harder to maintain. The important implication is that a major effort to strengthen the economy for the long term should be completed by 2010.

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



The three alternative paths for the deficit are shown in figure 3, along with the result of the no action scenario.

Our analysis of the three alternative paths shows that the balance and surplus paths present strong advantages relative to muddling through. During the early part of the period, the muddling through option seems easier, but as time passes the amount of policy action required to maintain the 3 percent deficit becomes larger and larger. The largest problem of all is at the end of the projection period. To hold the deficit to 3 percent of GNP in 2020, the deficit reduction actions affecting that year (whenever they might be enacted) would have to total half a trillion 1992 dollars. 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.

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

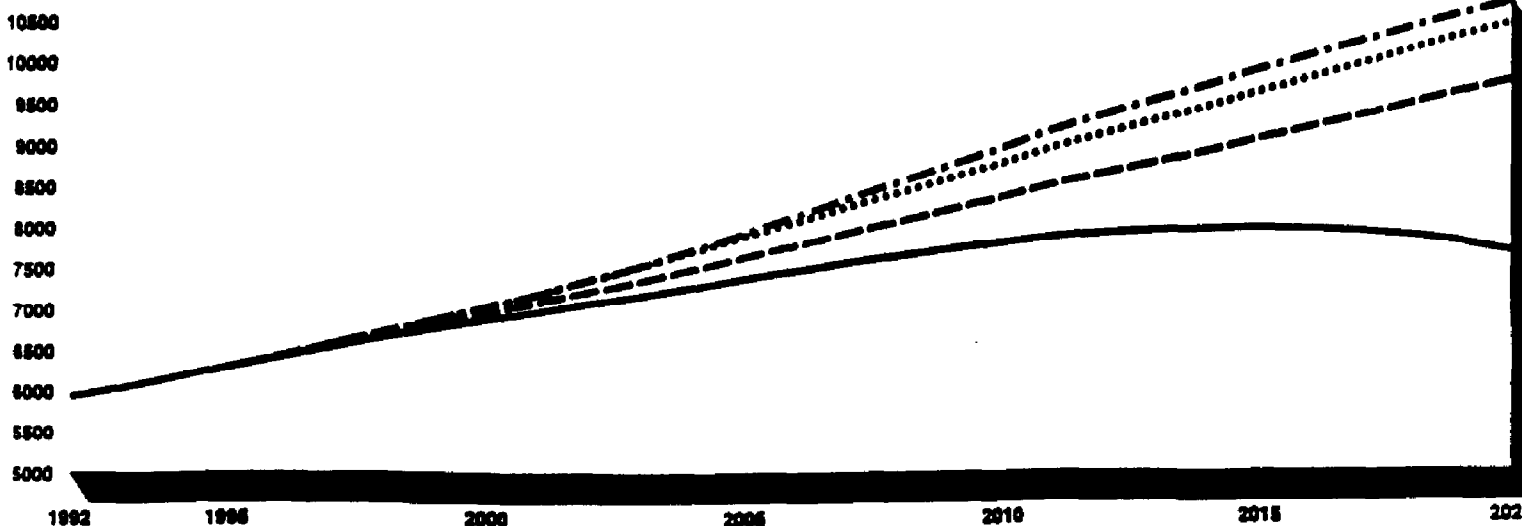
<u>Deficit Paths</u>	<u>Real GNP</u>	<u>Foreign Debt<sup>a</sup></u>	<u>Debt Held By the Public<sup>a</sup></u>
No action	\$23,875	\$19,243	\$45,816
Muddling through	\$30,374	\$ 8,460	\$16,702
Balance	\$32,555	\$ 3,748	\$ 4,665
Surplus	\$33,353	\$ 1,979	\$ 219

a The value identified as "foreign debt" in the table is the negative of the Net International Investment Position; the narrow term "debt" is not strictly appropriate. Also, the value for foreign debt and federal debt held by the public cannot meaningfully be added, since some of the U.S. debt held by the public is held by foreigners and forms part of the Net International Investment Position.

Figure 4 shows the different GNP growth paths generated by our different assumptions about the deficit and national saving.

Figure 4: Real GNP (1992-2020)

11000 1992 Dollars in billions



— No Action  
 - - - Muddling Through  
 ..... Balance  
 - . . Surplus

Since the major purpose of deficit reduction is to use more of current output for investment and less for consumption, it is no surprise that consumption is adversely affected in the near term. More stringent deficit reduction measures produce correspondingly larger adverse effects. In the long term, however, the higher national saving rate brought about by deficit reduction is reflected in higher levels of consumption as well as in greater output and reduced indebtedness.

Choosing either the balance or the surplus policy path can be a preemptive strike against the inexorable spiral driven by Social Security, health and interest payments. These policies reduce the national debt in relation to GNP; indeed, the surplus path virtually eliminates it. In the long term, shrinking the claim of interest costs on the budget can make room for the rising expenditures on Social Security and health -- or, if those programs themselves are reduced, permit tax reductions or finance other needed expenditures.

The economy that emerges from the balance and surplus scenarios in 2020 is a healthy economy, capable of meeting the needs and aspirations of Americans in the years after that. By contrast, the economy that emerges from "muddling through" is a sick economy threatened by the prospect of serious crisis.

#### THE INTERNATIONAL DIMENSION

Recently, the U.S. system of national income and product accounts was revised to make Gross Domestic Product (GDP) rather

than Gross National Product (GNP) the primary measure of national output. This step brought the U.S. system of accounts into conformity with those used in most other countries. As has already become apparent, we nevertheless used the GNP in our analysis. The GNP is the superior measure when, as here, national saving and investment rates are central issues.

The difference between the GNP and the GDP is the Rest of the World (ROW) account. The ROW account reflects the incomes that Americans receive from earnings on assets located abroad, less the amount of income foreigners receive from earnings on assets located in the United States. The model employed in our projections incorporates a simple representation of the determination of these income flows. Essentially, the rest of the world is treated as analogous to a bank where the U.S. can make deposits or withdrawals or draw on a credit line. Every year there are income flows to or from this bank, corresponding to interest received on deposits or paid on advances. The quantity corresponding to the bank balance (positive or negative) is the Net International Investment Position (NIIP) of the United States. Every year, the level of the NIIP changes for a variety of reasons. One of these is captured in the model -- the level of net foreign investment (NFI), which is the excess of amount that Americans invest abroad over the amount that foreigners invest in the U.S.

The international dimension of the long-run economic outlook is important, contentious and analytically difficult. In the

1980s, an inflow of foreign capital permitted the U.S. to sustain domestic investment in the face of a decline in national saving. The associated shift in the Net International Investment Position in the course of the decade is imposing in magnitude: almost one trillion 1992 dollars. The long-term price of this reliance on foreign capital is that future profits and interest payments will flow abroad. Metaphorically speaking, while it is nice to have the bank credit line available if you are a little short, it is better not to be a little short in the first place.

By the same token, one of the benefits of increased national saving achieved through deficit reduction is that reliance on foreign capital will be reduced, and the Net International Investment Position may improve. Such an improvement would be a useful complement to increased domestic investment. Increasing our national "bank balance" -- or at least stopping its decline -- is a sensible way to prepare for a future in which there will be fewer American workers to support the population.

There is another side to this story, however. Foreign investment flows respond not just to the availability of savings, but also to the attractiveness of investment opportunities. And more attractive investment opportunities mean more jobs and a more prosperous economy, regardless of whether the investment is financed from domestic or foreign savings.

International capital flows thus establish an important link between the problem of the deficit and the other major concern of our new report, federal spending priorities. A major shift in

the nation's 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.

#### IMPROVING LONG-TERM DECISION MAKING

The analysis that I have outlined here, and that is presented in greater detail in our report, is itself intended to improve long-term decision making. It provides a long term perspective on the consequences of the deficit, the character of spending trends, and the implications of demographic factors. We hope that it will aid the Congress in setting a course away from the major hazards that confront us and toward a more prosperous economic future.

Thus, one suggestion for improving long-term decision making would be to continue to pursue the kind of analysis that we have undertaken, so as to establish a better framework for decision making year by year. 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 displays the likely impacts of current decisions on long-term growth would help focus the debate on the choices we face. 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.

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 greatly in their impacts on the economy, the present budget process and structure do not encourage decision makers 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 feature of the budget process, a new framework for decision making 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. Better information and a stronger long-term focus are needed throughout the budget process, at all levels of aggregation or detail, and in the Executive Branch as well as in the Congress.

In our report, we present a modified version of GAO's proposal for a revised budget structure that would distinguish between capital and operating expenses. The modification involves a new distinction between "federally-owned capital" and "developmental investments" -- essentially, the distinction is between investment in capital assets that the federal government itself uses and investment that strengthens the economy as a whole. We believe that this structure provides helpful insight and would help to support a long-term focus in decision making. We are not, however, under the illusion that this proposal is a silver bullet. Where information to support decision making is concerned, there are no silver bullets -- and if there were, we would still need good management in implementing the decisions. There are, however, numerous opportunities to provide better informational support for decision making that we have provided in the past.