STATEMENT OF

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Mr. Chairman, I am happy to appear here today to present to the House Budget Committee the budget reduction report that you and a bipartisan group of members of this committee requested from the Congressional Budget Office last September.

The report, entitled Reducing the Federal Budget: Strategies and Examples, Fiscal Years 1982-1986, contains 105 examples of actions to reduce federal spending and tax expenditures that the Congress might wish to consider while deciding the direction the federal government should take in fiscal year 1982 and subsequent years.

There are four points I want to emphasize about the examples. First of all, they are just that--examples. We have compiled an illustrative, not an exhaustive, list of actions the Congress might take to reduce federal spending or deficits over the next several years.

Second, the inclusion of an item on the list, or its omission from it, does not imply a recommendation by the Congressional Budget Office (CBO). In a short discussion accompanying each item, we have provided a capsule of the arguments for and against the particular measure, but CBO takes no position as to which should prevail.

Third, I want to caution against adding up the estimated savings to reach a grand total for the 105 items. Some of them are alternatives to others, and so cannot be added together; and some may affect the size of other federal programs in ways that are difficult to estimate, making it impossible to state a precise net effect on the federal budget if all the non-overlapping examples were actually adopted by the Congress.

Finally, the examples are all actions that, either immediately or ultimately, reduce the benefits, services, or subsidies provided by federal programs, compared with what would occur if current policies were maintained. Because each example violates the status quo, each could be controversial. There are no easy targets on the list. There are none that would not result in some people or institutions being worse off than they would otherwise be.

In the remainder of this statement, I will discuss three general strategies for restraining growth in the federal budget: consolidating and reducing grants to the states, limiting entitlements, and lowering tax expenditures.

Consolidating and Reducing Grants to the States

Definite outlay savings can be achieved if the Congress combines multiple and related categorical grant programs into a single block grant and appropriates a new total that is less than the sum of the parts.

There are several arguments for such a course. One often made is that the states are closer to the actual problems and can do a better job than the Congress in allocating the dollars involved. This raises the prospect that program goals might not suffer even though the dollars were fewer. State and local officials have occasionally expressed a willingness to accept lower totals in return for the greater flexibility and lesser complexity inherent in a block grant.

Another argument for combining categorical into block grants is that doing so will reduce the amount of paper to be processed, while at the same time eliminating the vexing inconsistencies in funding cycles, application due dates, grantee eligibility rules, and the like, that are the hallmarks of programs involving multiple levels of government.

On the other hand, this strategy might also bring problems. Block grant funds would certainly not be spent for the identical purposes, or in the same proportions, or by the same localities, or for the same beneficiaries, as the funds previously targeted by the Congress in the categorical grants. If this were not so, there would be little point to the consolidation. It is almost equally certain that those who were disappointed with the manner in which block grant funds were distributed would return to the Congress seeking a new set of arrangements.

To take a historical example, the Community Development Block Grant (CDBG) program legislated in 1974 combined seven separate categorical programs. CDBG funds, which amounted to $3.9 billion in 1980, can be spent for the same purposes as the previous programs; this includes encouraging private economic development. Even so, the Congress in 1977 added a new $400 million categorical program for private economic development--Urban Development Action Grants (UDAG)--and subsequently raised its authorized level to $675 million.

In summary, the consolidation of categorical programs into block grants can lead to a reduction in federal spending, but the savings will be significant only if the Congress appropriates less for the single new program than it did for all the old programs, and only if it resists future claimants who do not like the outcome of state and local allocation decisions under the block grant system.

Revising Entitlement Eligibility and Benefits

Benefits to individuals accounted for 49 percent of federal spending in fiscal year 1980, and most of those benefits took the form of entitlements. In short, half of all federal outlays are driven by statutory formulas rather than by annual appropriations decisions. Reexamination of those formulas is a necessary part of any concerted effort to restrain the size and growth rate of the federal budget. But if that reexamination is to lead to spending cuts, the Congress will need to reduce the number of people eligible for benefits under continuation of current law, or lower the amounts they receive, or both; there is no other way.

Eligibility changes could be made so that cuts in benefits fall primarily on those least in need of assistance. For example, the demographic trends that are helping to force up the total costs of Social Security retirement benefits could be offset by raising the normal retirement age to, say, 68. This would reduce benefits to those most capable of working, while leaving unaffected the more elderly beneficiaries. Gradual phasing in would be necessary to avoid injuring those persons who have already made commitments on the basis of current law, but eventual savings would be substantial.

Another option for targeting assistance on the most needy would restore the family income ceiling on eligibility for guaranteed student loans. If a ceiling of $40,000 per year was applied only to students not borrowing at present under the program, outlays would decline by less than $100 million in 1982 but by $1.6 billion over the 1982-1986 period.

The benefits people receive could also be lowered. As an example of such a change, the rate at which food stamp benefits are reduced in response to increased incomes could be raised. Increasing this rate from the current 30 percent to 32.5 percent would reduce federal outlays by $675 million in 1982 and by $3.9 billion over five years.

The most important cause of rising federal spending for entitlements in recent years has been inflation. Practically every federal benefit

program is indexed to the cost of living, either by law or as a matter of practice. The July 1980 cost-of-living increase mandated by law for Social Security has alone added $17 billion to fiscal year 1981 spending. Each one percentage point rise in the Consumer Price Index (CPI) increases federal outlays for indexed programs by about $2 billion a year. It is hard to see how the growth in federal spending can be significantly reduced without changing these indexing provisions.

The Congress could revise the indexing of benefits to reflect changes in the cost of living more accurately, or it could limit the increases to amounts less than the full cost-of-living changes, or both.

One deficiency in the present system of indexing is that the CPI overstates the actual rise in the cost of shelter and the importance of housing in total living costs. In its 1982 budget, the Carter Administration proposed switching to a variant of the CPI, the CPI-XI, which is based on a rental-equivalence approach to measuring housing costs. If the change was implemented in time to affect the July 1981 adjustment in Social Security benefits, fiscal 1982 outlays would be reduced by about $2 billion. The impact on federal outlays in future years is very difficult to predict, however, and such a change cannot be counted upon to reduce federal spending in the long run.

The Congress also could cap the indexing of benefits. For example, limiting the July 1981 Social Security benefit increase to 85 percent of the increase in the CPI would lower fiscal year 1982 spending by about $2.8 billion. Such a cut might be defended on the ground that Social Security benefits have been increasing at a higher rate than earnings and are expected to do so again this year. But if an 85 percent cap was made permanent, substantial declines in benefit levels would ultimately result. For example, by late 1986, benefits for the average retired worker would be about 8 percent lower than they would be if current policies were continued.

Alternatively, Social Security benefits could be indexed to a cost-of-living measure or a wage-level measure, whichever was lower. This would mean that in normal years, when wages were rising faster than prices, the purchasing power of benefits would be protected. In periods of recession, however, when wage increases lagged behind price increases, Social Security beneficiaries would be called on to make sacrifices comparable to those of wage earners. This option would reduce federal outlays by an estimated $3.8 billion in 1982 and $26.1 billion over the 1981-1986 period. Over time, it would lower real benefits below the levels anticipated under current law, but this reduction would probably be less than that involved in moving to a permanent 85 percent cap. Either this option or the cap could also be applied to military, Civil Service, and Railroad Retirement pensions. In that case, savings would be increased.

Finally, the Congress could make cost-of-living increases less automatic by instituting a procedure like the one now used to adjust white-collar federal pay scales. Each year the President could propose a cost-of-living increase not to exceed the rise in the CPI. The recommendation would take effect unless the Congress acted to alter it. Such a procedure would permit tailoring benefit increases to current economic and fiscal conditions.

Cutting Tax Expenditures

If one objective is to reduce the federal deficit, an alternative to reducing spending is to reduce tax expenditures--that is, those provisions of the tax code that exclude certain income from taxation in order to further particular policy objectives. As an example, the exclusion of employer-paid health insurance benefits from employees' taxable income, and from the Social Security earnings base, could be restricted. In 1982, this tax expenditure will account for a revenue loss of $28 billion. Limiting the exclusion to $120 per month in 1981 and indexing the limit thereafter would raise $2.6 billion in revenues in 1982 and $25 billion over five years. Health care costs might be restrained as well, since the exclusion leads to what many consider to be overly extensive health insurance coverage, which increases both the use of medical services and medical care prices.

Another very large tax expenditure is the financial assistance furnished to homeowners in the form of the deduction for mortgage

interest. This very popular subsidy benefits about 40 percent of all homeowners, at a 1982 revenue cost of about $25 billion.

Recent economic studies suggest that the deduction may have important adverse consequences both for housing markets and for the economy as a whole. Besides creating substantial losses of federal revenues, it appears to have contributed both to a serious decline in the construction of rental housing and to the conversion of rental housing into condominiums and cooperatives. In addition, the deduction has promoted the rapid rise of home prices and encouraged the flow of individual savings into housing rather than into productive capital.

If the Congress wished to reduce the revenue loss from the deduction, the simplest option would be to limit the amount of mortgage interest that could be deducted. For example, if a ceiling of $5,000 was set effective January 1, 1981, the savings would be about $4.3 billion in fiscal year 1982.

A third tax subsidy example is the deduction for interest paid on credit purchases of consumer goods. The deduction will provide $6 billion in tax relief this year to consumers who borrow to make their purchases; no similar program exists to aid those who pay cash. Reduction of this tax expenditure might serve to discourage consumption and encourage saving.

Whether the tax expenditures just cited, or any others, should be limited or cancelled is clearly a matter for debate, but what is beyond debate is that they influence the size of the federal deficit in just the same fashion as direct spending programs. When a tax subsidy is halted, the resulting savings can be used to fund some other program, to reduce the national debt, or to help finance a tax cut.

Conclusion

The task of controlling federal spending and deficits will be a difficult one. It will require the cooperation of the authorizing committees, the appropriations committees, the tax-writing committees, and the budget committees. An example of such cooperation was the series of actions taken by the last Congress to control spending through the reconciliation process. Legislation passed as part of this process reduced fiscal year 1981 outlays by $4.6 billion and increased revenues by $3.6 billion.

The single-year nature of our budget process makes controlling federal spending and tax expenditures especially difficult. A large proportion of spending and tax expenditures cannot be altered for the next fiscal year because of legal and moral commitments to those who benefit from government programs. Given a few years' lead time, however, major changes can be effected. The problem is how to bring the out-year implications of policy decisions to bear upon the current year's budget and appropriations and tax-writing processes.

Procedural changes in how the Congress makes its budget decisions might be considered. One option, which CBO has recommended, would have the Congress vote binding advance budget targets, perhaps for the budget year and the four following years. The targets would have to be reviewed each year, but their existence would focus attention on out-year implications of spending and taxing proposals, and would require the Congress to weigh more carefully legislation whose major impacts on the budget are not realized for several years.