CBO TESTIMONY

Statement of
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Committee on Finance
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NOTICE

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Mr. Chairman and Members of the Subcommittee, I appreciate the opportunity to appear here to discuss how budget deficits affect long-term economic growth.

The Congressional Budget Office agrees with the Government Accounting Office and most economists that large persistent federal deficits dampen the rate of productivity and economic growth. Ultimately, deficits of the sort this country has experienced for over a decade keep living standards from attaining the level they could reach if the deficits were smaller. The problem is all the more pressing because the deficits occur at a time when other factors--low private saving rates, the slow growth in productivity, and demographic trends--will also tend to restrain the improvement of living standards.

Policymakers as well as economists widely recognize these arguments. But recognizing and understanding a problem is not the same as doing something about it: after more than two decades of discussion and procedural changes, we still do not have either agreement on the policy changes necessary to cut the deficit or the procedures that will effectively bring about a budget close to being balanced.

Many are now determined to try another procedural innovation: enshrining a balanced budget in the Constitution. I fear that the con-

stitutional approach could divert attention from the fundamental job of deciding what spending is to be cut or what taxes are to be increased. Inevitably, these decisions must be made, with or without a constitutional amendment. Nevertheless, I am sympathetic with the underlying aim of the amendment--namely, to keep the need for deficit reduction at center stage.

LOWER GOVERNMENT BORROWING WOULD INCREASE GROWTH

Without a doubt, reducing government borrowing will reap very real long-run benefits. Lower deficits would encourage economic growth in the long term by raising net national saving and investment, and would reduce borrowing from foreigners. From an accounting point of view, any reduction in the deficit--provided it does not come out of government investment--is a reduction in government dissaving and, therefore, an increase in national saving.

Although some analysts are concerned that private saving will decline as government dissaving drops, the offset is not likely to be particularly large. Studies indicate that reducing the deficit by one dollar might reduce private saving by 20 cents to 40 cents, which implies that national saving will increase

by 60 cents to 80 cents for every dollar of deficit reduction.[1] More net investment and lower borrowing from foreigners, both of which depend on increased national saving, will eventually permit a higher standard of living.

Deficit reduction will also promote long-term economic growth by providing a more stable environment for financial markets. Participants in the bond, stock, and foreign exchange markets carefully track the government's demands on credit markets; they react adversely to news that reflects a continuing lack of fiscal discipline.

As deficits fall and the pool of funds available for loans to the private sector grows, interest rates adjusted for inflation should drop. Lower interest rates will help to stimulate activity in interest-sensitive sectors, such as construction and business investment. They will also aid in making the dollar more competitive, thereby boosting exports and helping domestic producers to compete with imports.

Because government borrowing reduces investment and slows growth in the long run, it will impose a burden on future generations, and, in many

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1. See Lawrence H. Summers, "Issues in National Saving Policy," in Gerald F. Adams and Susan M. Wachter, eds., *Savings and Capital Formation* (Lexington, Mass.: Lexington Books, D.C. Heath & Co., 1986), pp. 65-88; and Michael J. Boskin, "Alternative Measures of Government Deficits and Debt and Their Impact on Economic Activity," in K. J. Arrow and M. J. Boskin, eds., *Economics of Public Debt* (New York: Macmillan, 1988), pp. 72-112.

people's minds, this is the single most important reason to reduce the federal deficit. The burden is in part reflected in the interest costs of servicing the federal debt. As you well know, these costs have already risen from 8 percent of tax revenues in the 1970s to 18.6 percent of revenues in 1991. The only way to reduce these costs is to reduce federal borrowing.

Is the Deficit All that Matters for Growth?

Although the federal deficit is only one of the channels by which federal fiscal policy can affect growth, an examination of the other major channels--federal government investment and tax policies--does not improve the outlook. The deficit tells us how much the federal government's borrowing takes out of the pool of private saving, and thus how much it cuts into private investment. In addition, we should look at the government's own investment--which can be as effective as private investment in generating growth--and at the effects of tax policy on the incentives for private saving and investment.[2]

Federal Investment Spending. Rising federal deficits would not adversely affect growth if they financed productive investments in such things as infrastructure and education. Education is an important factor in growth.

2. See Congressional Budget Office, *The Federal Deficit: Does It Measure the Government's Effect on National Saving?* (March 1990).

Perhaps as much as one-quarter of the growth in output per worker from 1929 through 1982 was attributable to increased education--mostly government financed, though not by the federal government. In the past, federal spending on infrastructure has been about as successful as private investment in promoting growth. Maintaining this record will be difficult because the most productive infrastructure projects--such as the interstate highway system--have already been completed. Nevertheless, spending on public investment could still be as productive as private investment if the projects are carefully chosen.

The current and projected federal deficits do not reflect increased investment spending, however. As conventionally measured, federal investment as a share of gross domestic product (GDP) in constant dollars has fallen slightly over the last 20 years, and projections for the near future indicate little change in that share.

Changes in Taxation. Reducing the deficit by raising revenues is not the only way tax policy can improve future living standards. By influencing how much and where people work, save, and invest, taxes also help determine how efficiently society uses all its resources and how much of those resources are devoted to investment for the future. In particular, for a given level of the deficit, a tax system that increased incentives to save or invest might enhance future output and productivity by encouraging more capital formation.

Usually, however, the effects of such a tax system on incentives are small or uncertain compared with the direct boost that lower deficits give to national saving.

Standard principles suggest two broad strategies for tax design for economic efficiency. First, minimize tax preferences that subsidize narrow sectors or activities. This step would increase efficiency by leveling the playing field--taxes would play a smaller role in private decisions--and it would permit lower rates by broadening the tax base. Second, make private parties pay more of the cost of the resources they use. This strategy obviously applies to narrowly provided government services such as those for air, water, or highway transportation. But it could also apply to broad national problems, such as environment and energy, because pollution and dependence on energy impose costs on our society that are not now reflected in market prices of the activities that generate those costs.

Economic efficiency might also justify shifting taxes toward consumption, but designing incentives to save or invest would require care. Greater incentives to save or invest could be provided within the current tax system or by introducing a consumption-based value-added tax (VAT) to replace the individual and corporate income taxes. A European-style VAT is a direct way to shift the tax burden from saving to consumption without

introducing new dislocations in the income tax. But a VAT would impose additional costs of administration and compliance on taxpayers and the Internal Revenue Service, and it could introduce new efficiency costs if some goods and services are exempted. In addition, available evidence suggests that the response of saving to changes in tax rates is small and uncertain.

Tax policy might also increase efficiency by making the treatment of income from corporate and noncorporate investment more even, but again there might be problems. For example, lowering the corporate tax rate would apply to old capital, as well as new investment. Investment tax credits or accelerated depreciation schedules would apply only to new investment. But they are difficult to design if they are to apply uniformly to all types of investment. Nonuniform treatment can sometimes lead to substantial waste. During the early 1980s, for example, the combination of accelerated depreciation and favorable treatment of capital gains is believed to have contributed substantially to the excess of commercial construction.

It is certainly worthwhile to seek to improve the efficiency and reduce the distortions of the tax system. Nevertheless, as these examples have shown, tax reform is unlikely to offer as large an opportunity for enhancing long-term growth as would be gained by simply reducing federal borrowing, and in that way increasing national saving.

Unless there is further legislation to reduce the deficit, however, the problem of excessive government borrowing is not going to resolve itself. For a few years, it will look as if things are getting better: the federal deficit could fall from around 6 percent of gross domestic product in the current fiscal year to around 2.5 percent in 1996 (see Table 1). But this apparent improvement is largely the result of the rebound from the current recession and the swing in the deposit insurance accounts. Together, these two temporary factors account for about 43 percent of this year's deficit.

The more revealing calculation excludes these two factors and examines the longer-range outlook. From this perspective, the standardized-employment deficit rises from around 3 percent of GDP in the early 1990s to 4 percent in 2002 (see Table 1 and Figure 1). This increase will take place even with the substantial policy changes that will be necessary to meet the discretionary spending targets of the Budget Enforcement Act. As the figure shows, the standardized-employment deficit as a percentage of potential GDP was historically high during the 1984-1991 period. That record, however, is likely to be challenged by the sustained high deficits that are projected through 2002.

Table 1. The Budget Outlook Through 2002 (By fiscal year)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
In Billions of Dollars											
Revenues	1,088	1,173	1,262	1,340	1,413	1,490	1,578	1,665	1,755	1,851	1,953
Outlays	1,455	1,510	1,529	1,543	1,602	1,726	1,843	1,962	2,089	2,226	2,376
Deficit	368	336	267	203	189	236	265	296	333	375	423
Standardized-Employment Deficit[a]	208	198	186	179	202	245	262	289	322	360	406
Debt Held by the Public	3,049	3,385	3,656	3,865	4,061	4,304	4,576	4,879	5,220	5,602	6,032
As a Percentage of Gross Domestic Product											
Revenues	18.6	18.8	19.1	19.1	19.1	19.0	19.0	19.1	19.1	19.1	19.1
Outlays											
Discretionary	9.4	8.7	8.1	7.7	7.5	7.3	7.2	7.1	7.0	6.8	6.7
Mandatory											
Social Security	4.9	4.8	4.8	4.8	4.8	4.8	4.8	4.8	4.8	4.8	4.8
Medicare/Medicaid	3.4	3.6	3.7	4.0	4.2	4.4	4.7	4.9	5.2	5.5	5.9
Other	3.9	3.7	3.5	3.4	3.2	3.3	3.2	3.2	3.1	3.1	3.1
Subtotal	12.1	12.0	12.0	12.1	12.2	12.4	12.6	12.9	13.1	13.4	13.7
Deposit insurance	1.1	1.1	0.5	-0.2	-0.6	-0.4	-0.2	-0.2	-0.1	-0.1	-0.1
Net interest	3.4	3.4	3.5	3.5	3.5	3.6	3.6	3.6	3.7	3.8	3.8
Offsetting receipts[b]	-1.2	-1.1	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0
Total	24.9	24.2	23.1	22.0	21.6	22.0	22.2	22.5	22.7	23.0	23.3
Deficit	6.3	5.4	4.0	2.9	2.5	3.0	3.2	3.4	3.6	3.9	4.1
Standardized-Employment Deficit[a, c]	3.4	3.1	2.8	2.5	2.7	3.1	3.1	3.3	3.5	3.7	4.0
Debt Held by the Public	52.2	54.3	55.2	55.2	54.8	54.8	55.2	55.9	56.7	57.8	59.1

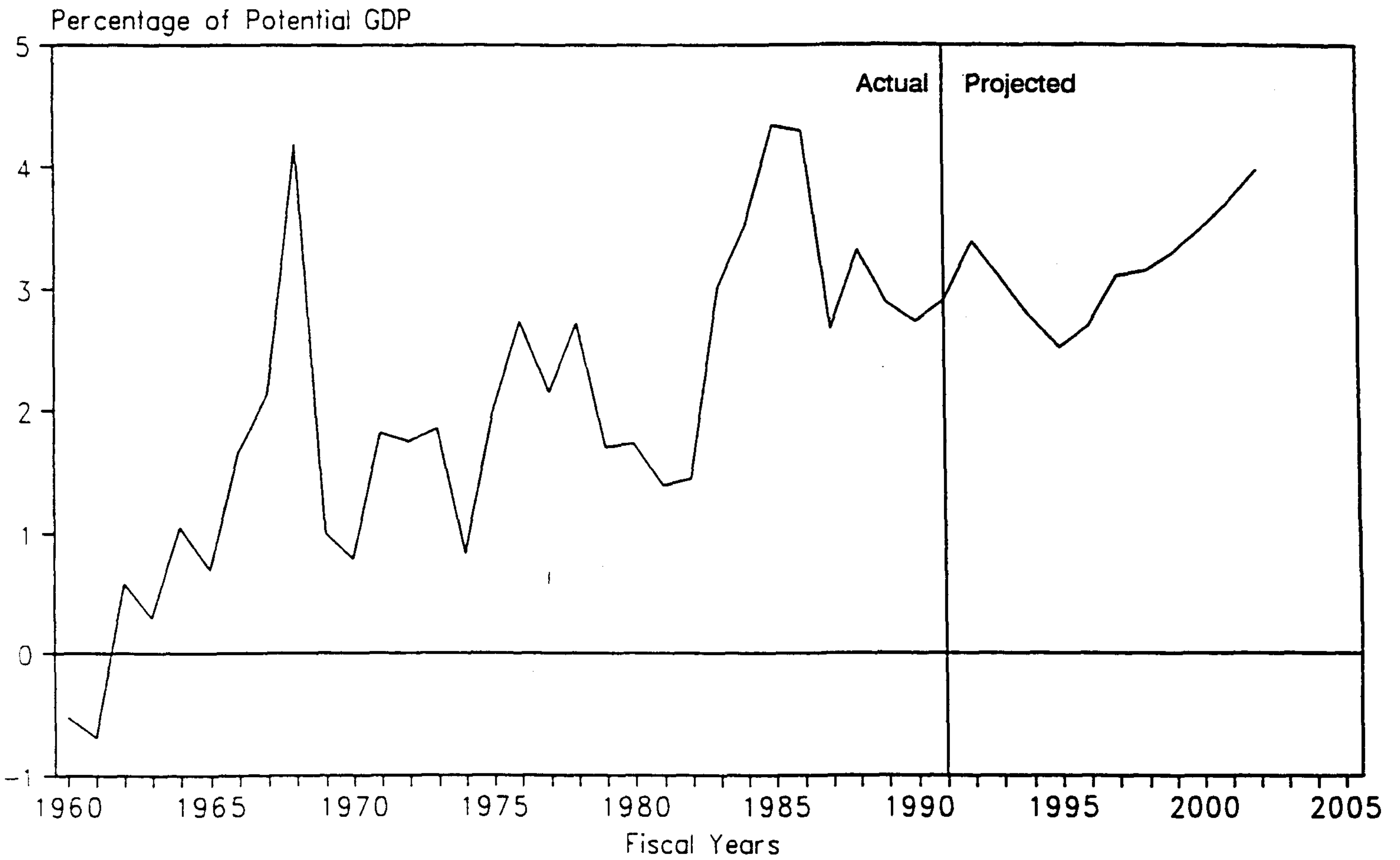
SOURCE: Congressional Budget Office (March 1992).

a. Excludes deposit insurance and Desert Storm contributions.

b. Includes contributions from allied nations for Operation Desert Storm.

c. Shown as a percentage of potential gross domestic product.

Figure 1.
The Standardized-Employment Budget Deficit



Source: Congressional Budget Office.

The persistence of large deficits would cause the debt held by the public to climb to more than 59 percent of GDP by 2002 under current policies, up from 52 percent today. Not since the mid-1950s (when the debt-to-GDP ratio was still heavily affected by the debt burden accumulated during World War II) has the debt-to-GDP ratio been so high.

The projected long-run increase in the deficit as a share of GDP stems from an acceleration in the projected growth in outlays that is not matched by a corresponding growth in revenues. Revenues remain at about 19 percent of GDP throughout the projection period, but outlays climb from 21.6 percent of GDP in 1996 to 23.3 percent in 2002. The growth in outlays is mostly in the government's big health care programs, whereas discretionary programs--defense, international, and domestic--gradually decline relative to GDP. Most other spending programs, including Social Security, roughly preserve their 1997 shares in the out-years. Social Security benefits stay at about 4.8 percent of GDP through the projection period, but they will begin to rise rapidly a few years after 2002 as the baby-boom generation reaches retirement age.

These projections would be even higher were it not for the severe restraint the Budget Enforcement Act imposes on discretionary spending through 1995. Yet, these limits will be hard to meet. After the required real reductions of 3 percent for 1993, the Congress will have to pare discretionary

spending by an additional 4 percent in 1994 and a further 3 percent in 1995 to comply with the act. If these limits are not adhered to, deficits will be even greater than the baseline projection indicates, and the task of getting them under control will be correspondingly more onerous.

WILL THE BALANCED BUDGET AMENDMENT HELP?

Over the course of the past two decades, a number of procedural steps have been taken in an effort to rationalize budget policy and control the deficit. These measures include the Congressional Budget and Impoundment Control Act of 1974, the Balanced Budget Act (Gramm-Rudman-Hollings legislation) of 1985 and 1987, and the Budget Enforcement Act of 1990. Although they have heightened the attention paid to budget decisions and have helped restrain the deficit somewhat, they have not reduced the deficit to acceptable proportions.

The balanced budget amendments that are under consideration are another attempt to set up a procedure that will make the deficit even more central to Congressional budgetary decisions; indeed, such an amendment will make eliminating the deficit the single most important consideration of budgetary policy. Proponents hope that by enshrining a balanced budget in

the Constitution, they will raise the stakes and force the hard decisions about spending cuts and tax increases that have not yet been made.

I am not sanguine that such a favorable result could be achieved for two reasons. First, the balanced budget amendment does not do anything to make the specific decisions to cut spending or raise taxes any easier. Second, any balanced budget rule could too easily be circumvented. Some methods that may be used to circumvent the rule, such as creating a capital budget, have some justification. Others would, however, be similar to the budget gimmickry and legerdemain that flourished in the Gramm-Rudman-Hollings era--for example, using optimistic economic assumptions, shifting expenditures off-budget, and changing the timing of receipts and outlays.

In a capital budget, the cost of outlays for capital items in the budget would be replaced by depreciation and thus would be spread out over a longer period of time to account for the long-lived nature of the assets acquired. Government capital spending may currently be disadvantaged, because its costs are front-loaded relative to the benefits that flow from such projects. A change in the budgetary treatment of capital spending would eliminate the up-front budget cost and thus might promote more capital investment. It is difficult, however, to put the concept of a capital budget into practice, primarily because so much depends on subjective assumptions

concerning what capital is and how it is to be measured. Capital budgets at the state level have traditionally included only physical assets. Yet, investments in human capital (such as education) also have long-term economic benefits, and most economists would say they are investment just as legitimately as any physical building. Moreover, the creation of two categories of spending may increase playing games with budget definitions, particularly if policymakers seek to have their favorite programs classified as "investments," regardless of the actual contribution of the spending to economic growth.

Concurrent Actions Are Needed to Achieve Fiscal Discipline

A balanced budget amendment risks ignominious failure if it is not accompanied by a definite plan for reducing the deficit fast enough to reach a balanced budget in the time envisaged by the amendment. If a balanced budget amendment is approved and sent to the states for ratification, the Congress will be obligated to begin immediately to take the steps necessary to comply with a balanced budget regime.

To avoid the need to make sudden, draconian cuts in spending or massive, abrupt tax increases, efforts should be made to bring the deficit down

substantially during the ratification period. Although this task is by no means easy--it is the problem that has bedeviled the budget process for the past decade--it is critical. If the amendment takes effect with the deficit still in the hundreds of billions of dollars, the Congress would be faced with the Hobson's choice of enforcing the new rule and inducing a recession or waiving the rule from the start, which would clearly be an inauspicious beginning for the new era.

It would be preferable for the President and the Congress to reach a consensus concerning the appropriate mix of policy changes necessary to achieve the goal of budgetary balance well before the effective date of the amendment. If such a consensus were not reached, however, transition legislation would need to specify methods to force a reduction in the deficit in a more automatic and mechanized way. Two different broad paths could be taken--granting power to the President to carry out budgetary changes without the specific action of the Congress, or resorting to formulas as was done in the Gramm-Rudman-Hollings act to effect automatic reductions if an agreement on alternatives was not reached.

Each of these paths would involve substantial constraints on the flexibility of policymaking and a substantial alteration in the distribution of power to make budget policy. Most analysts would not favor as a permanent

diet the rigid specifications of the budget process that would be required for the transition period. The fail-safe procedures are too mechanical, and they would throw to the winds both countercyclical fiscal policy and the automatic economic stabilizers. But just such rigidity may be necessary to have a chance of making a successful transition to a new regimen of constitutionally mandated balanced budgets. Without a consensus on national goals--or drastic procedural measures that can enforce action in the absence of consensus--a balanced budget amendment is doomed to failure.

How Big Must the Policy Changes Be?

Let me now address what it will take to comply with the amendment if a balanced budget is required by 1997. Balancing the budget in five years is difficult but not impossible. For example, spending decreases and tax increases totaling $40 billion in 1993, $80 billion in 1994, and growing to $200 billion by 1997, together with the resulting saving in debt-service costs, would do the trick. Over five years, the required deficit-reduction measures would total about $600 billion, which is a bit more than 40 percent larger than the savings called for in the 1990 budget summit agreement.

This illustrative path is based on CBO's current economic and technical estimating assumptions and therefore ignores the effects on the economy of attempting to balance the budget. It should, however, be fairly close to the mark. To the extent that the deficit-reduction effort reduces overall demand and lowers income and employment, tax collections would be impaired, and the task of balancing the budget would be made harder than those numbers suggest. To the extent that interest rates are also reduced, however, the government's cost of borrowing would be lower, and the job would be made easier. Although these two effects will not precisely offset each other, the budgetary feedbacks are likely to be small.

DEFICIT REDUCTION NEED NOT CAUSE SEVERE HARDSHIP

Although deficit reduction will initially reduce the rate of economic growth, the short-run hardship can be lessened if the reduction is carried out in a credible and consistent way. A credible long-term plan would encourage a drop in long-term interest rates, permit an easing of monetary policy, and foster a smoother adjustment by the private sector to the changes in government spending and taxation policies.

Long-term interest rates are higher when financial markets anticipate large federal deficits in the future. The high rates depress investment. If the Congress and the Administration took steps that convinced financial markets that future deficits will be lower than currently anticipated, long-term rates would ease, thus stimulating investment. Unfortunately, the experience of the last decade has led participants in financial markets to be skeptical of promises to reduce government borrowing. Although it is not clear exactly what actions would be necessary for a deficit-reduction plan to become credible to the markets, the actual passage of bills that specified particular tax increases or spending reductions would clearly be more credible than procedural reforms.

A credible plan for deficit reduction would also permit the Federal Reserve to provide more monetary stimulus, since fiscal policy would be less expansionary and the threat of inflation smaller. The Federal Reserve eased monetary policy in the wake of the passage of the Budget Enforcement Act of 1990, and similar deficit-reduction efforts are likely to encourage easier monetary policy in the future. Both long- and short-term rates would therefore be lower than they would have been without deficit reduction, and this change would offset part of the initial dampening effect of deficit reduction.

A deficit-reduction plan that resulted in a consistent fiscal policy would also help minimize the short-run adverse effects. Individuals, businesses, and communities could clearly respond more effectively to deficit reduction if the long-run pattern of federal spending and taxation policies were relatively predictable.

CONCLUSION

The budget outlook is grim, particularly given other developments in the last decade that indicate slower growth in living standards in the future. Investment and the long-run outlook for growth in labor productivity and living standards have been adversely affected by the persistently large standardized-employment deficits of the 1980s, and there is no relief in sight. Policy changes, particularly deficit reduction, can improve the long-run outlook for living standards, but these changes will be difficult to make and may entail a lower level of consumption and living standards in the short run.

The initial sacrifice could be reduced, however, if a credible and consistent long-run deficit-reduction policy is combined with an easier monetary policy. A balanced budget amendment, by itself, is unlikely to provide sufficient credibility to minimize the adverse short-run effects of

deficit reduction. Markets will have to be convinced early in the process that the difficult decisions regarding specific taxes and spending policies are being made if we want to keep the short-run costs of deficit reduction low.