CBO TESTIMONY

Statement of
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before the
Subcommittee on Deficits, Debt Management,
and International Debt
Committee on Finance
U.S. Senate

April 12, 1991

NOTICE

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Mr. Chairman, I appreciate this opportunity to discuss developing and using federal budget information to improve long-range decisionmaking. The federal budget serves a number of important planning purposes: it can be used to affect economic growth, to allocate scarce public resources, and to address concerns about income distribution, including the distribution of income among generations. The Congressional Budget Office (CBO) and others have been working on ways to improve the budget as a source of information for decisionmakers. Important strides have been made, such as credit reform, but much remains to be done.

My statement today will focus on the following topics:

- The budget outlook over the next five years under current policies;
- The effect of the budget on national saving and longer-run economic growth;
- Budgetary issues involving the allocation of resources, particularly the government's contingent liabilities; and
- Distributional issues and the generational accounting framework.

Some major temporary factors will push the federal deficit to around $300 billion in 1991, but the budgetary situation should improve markedly after 1992. The main reason for such improvement is that the temporary factors--the recession and the debacle in the savings and loan industry--begin to fade, and the savings from last year's budget agreement grow. The Omnibus Budget Reconciliation Act of 1990 will reduce federal borrowing over the next five years by nearly $500 billion, and sharply reduce the annual deficit both in dollars and in relation to gross national product (GNP). By 1995, assuming that the new legal limits on spending are maintained, CBO projects that the total federal deficit will fall below $100 billion for the first time in 15 years and below 1 percent of GNP for the first time in 20 years (see the Table on page 3).

Two other measures of the federal deficit are frequently used for analyzing policy. One is the deficit excluding deposit insurance. Outlays for deposit insurance to resolve failed institutions do not have significant effects on the economy or on interest rates. Federal outlays to close or subsidize the sale of insolvent savings and loan institutions and banks will total about $100 billion in 1991 and again in 1992. After that, however, these outlays will decline sharply, and turn negative in 1995 and 1996--in part because of the

CBO PROJECTIONS OF FEDERAL REVENUES, OUTLAYS, AND DEFICITS (By fiscal year)

	1991	1992	1993	1994	1995	1996
			In Billions of Dollars			
Totals Assuming Discretionary Caps[a]						
Revenues	1,093	1,169	1,251	1,331	1,415	1,495
Outlays	1,402	1,463	1,472	1,501	1,484	1,561
Deficit	309	294	221	169	69	66
Deficit Excluding Deposit Insurance	205	197	174	145	116	108
On-Budget Deficit (Excluding Social Security and Postal Service)	369	364	301	266	181	194
			As a Percentage of GNP			
Totals Assuming Discretionary Caps[a]						
Revenues	19.4	19.5	19.5	19.5	19.5	19.4
Outlays	24.9	24.4	23.0	22.0	20.5	20.3
Deficit	5.5	4.9	3.5	2.5	0.9	0.9
Deficit Excluding Deposit Insurance	3.7	3.3	2.7	2.1	1.6	1.4
On-Budget Deficit (Excluding Social Security and Postal Service)	6.6	6.1	4.7	3.9	2.5	2.5
Memorandum: Gross National Product (In billions of dollars)	5,624	6,003	6,405	6,813	7,246	7,705

SOURCE: Congressional Budget Office.

a. The discretionary spending caps apply only through 1995. The 1996 figure is an extrapolation.

return of working capital. Excluding deposit insurance, CBO estimates that the federal deficit will decline gradually from about $200 billion in 1991 to about $100 billion in 1996.

The other deficit that receives considerable attention is the on-budget deficit, which excludes the receipts and outlays of the Postal Service and the main Social Security trust funds (Old-Age, Survivors and Disability Insurance). Because Social Security is projected to run substantial surpluses for a number of years, the on-budget deficit is considerably higher than the total deficit. The on-budget deficit, projected at $369 billion in 1991, declines to $194 billion in 1996.

THE EFFECT OF THE BUDGET ON NATIONAL SAVING AND ON ECONOMIC GROWTH

The budget deficit is one important, though imperfect, summary measure of the government's effects on national saving and economic growth. The deficit reflects the rate at which the government reduces prospects for growth by absorbing private saving that would otherwise be used to expand the private sector's capital stock, and with it the future size of the economy. That is the primary reason for concern about sustained large budget deficits.

For all its faults, the budget deficit gives a clear message about the implications of current budget policies for long-run growth. The substantial increase in government dissaving during the 1980s will make later generations worse off because it will leave the economy with a smaller capital stock. CBO and others have spelled out that message recently with the help of growth models, which quantify the relationship between changes in the budget deficit, national saving, and economic growth.

Some analysts, particularly Robert Eisner of Northwestern University, argue that the current measures overstate the budget deficit and that it is smaller than most people realize. Among the more frequent criticisms are that the budget deficit is not adjusted for inflation or for net governmental investment. For the most part, adjustments for these factors can be made.

However, such attempts at refining the measure of the budget deficit do not change the overall conclusion that CBO and many other analysts have reached over the last decade: that the government has absorbed far more of the nation's saving than in earlier periods and that the future standard of living is likely to be lower as a result.

CBO explored these measurement issues in a recent report, which provides more detailed analysis.[1] Here, I will only briefly discuss why the adjustments for inflation and for government investment make little difference in conventional conclusions about fiscal policy. Economists often argue that inflation partially invalidates the usual measure of the federal deficit. Inflation reduces the real value of the government debt. Part of net interest on the federal debt, which increases budget outlays and the deficit, merely compensates bondholders for inflation. As a result, Eisner and others have argued that the deficit should be adjusted by subtracting the amount by which inflation cuts the real value of the outstanding debt in any year. But adjusting the budget deficit for the effects of inflation on the government debt does not change the conventional conclusion that deficits have risen sharply in recent years. As a result, the conclusions about the importance of reducing the deficit are unaffected.

As it turns out, adjusting the budget deficit for federal net investment also does not make much difference. Eisner and others argue, correctly, that to the extent that the government spends money for infrastructure, human capital, and other purposes that represent public investments, such spending does not divert saving to current consumption. They therefore propose

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

subtracting federal investment in order to arrive at a more illuminating measure of the deficit.

Even after this adjustment is made, the deficit turns out to have grown sharply in the 1980s, reducing prospects for economic growth. First, the scale of the government's nonmilitary investment relative to the size of the economy has not increased compared with the 1960-1979 period. Second, the amount of federal nonmilitary investment net of depreciation is relatively small. Gross investment by government is not small, but the estimated amount of depreciation on government capital is nearly as large.

Proposals for a Capital Budget

A number of analysts in the private sector, as well as the General Accounting Office, have advocated that the federal government adopt a capital budget. Doing so would mean removing federal investment outlays from the conventional budget and accounting for them separately. Only the deficit in the remaining budgetary accounts, usually called the "operating budget" (which includes depreciation), would then be viewed as reducing national saving and reducing economic growth.

Capital budgeting has a number of limitations. Since it is difficult to determine which programs should be considered investments, political

pressures would inevitably arise to classify more and more types of spending as investments in order to protect those programs from cuts intended to reduce the operating deficit. Health and nutrition programs are examples of expenditures that would be hard to classify: should they be included, and what about education programs?

Second, depreciation on government capital is extremely difficult to estimate. Because in many cases no market exists for the asset, its decline in value--depreciation--must be estimated. The problem is difficult for physical assets, and much more so for investments in human resource, or intangible investments in research and development. And yet depreciation would play a critical role in a capital budget. The operating budget would include depreciation of capital assets as an outlay, while the capital budget would include depreciation on capital as a revenue source.

Third, and perhaps most important, maintenance of a dual capital-operating budget makes it less likely that the full resource costs will be taken into account when decisions are made. Fundamentally, the budget is about setting priorities and budgeting scarce resources. For budgetary control, there is an advantage in recognizing the full cost of a decision to acquire an asset, when the decision is made to allocate resources irrevocably to a particular use. Since decisionmakers would be likely to focus only on the operating

budget, where only the current year's depreciation on federal investments would appear, they may well ignore the full resource costs of investments.

Because of such limitations, analysts do not agree about the desirability of capital budgeting. For instance, more than 20 years ago the President's Commission on Budget Concepts considered capital budgeting but rejected it. In an effort to provide useful information, the Office of Management and Budget (OMB) routinely prepares a special analysis of the budget on federal government investment, including projections. Since this arrangement highlights federal investment--which is important for achieving long-term goals--it is perhaps the best available compromise.

How Productive is Federal Investment?

Some recent analyses, such as work done by David Aschauer of Bates College, have attributed very high returns to federal investments in infrastructure (roads, sewers, and airports). Overall, however, the evidence suggests that government investment in such infrastructure, while productive, is not generally and significantly more productive than private investment. This overall conclusion seems to fit other broad categories of government investment as well. Some programs and projects offer the prospect of reasonable returns on the investments, but it is very difficult to generalize. In that sense, the recent controversy over Aschauer's work illustrates a

possible fallacy of capital budgeting--namely, that because an outlay is classified as an investment it is automatically promoting economic growth.

A case-by-case approach is necessary to assess the economic returns from government investments, including benefit-cost analysis of particular projects and programs. Benefit-cost analysis seeks to measure the streams of benefits and costs associated with an investment project, and to discount these flows so that they can be compared. A benefit-cost ratio of greater than one means that the project passes an important economic test: the investment pays at least as high a return as the average alternative use of the same resources. This is an appropriate criterion for decisions.

More Far-Reaching Critiques of Measuring the Budget Deficit

Some analysts have gone farther in their criticism of the federal deficit as a measure of the federal budget's effect on national saving. In particular, Alan Auerbach of the University of Pennsylvania and Laurence Kotlikoff of Boston University argue that current measures of the federal deficit are economically arbitrary. For example, they contend that some programs that affect the conventional deficit could arbitrarily be reclassified as loans that would not have an impact on the deficit.

Such reclassification would change the measured deficit substantially without affecting the economic impact of fiscal policy. In particular, Auerbach and Kotlikoff argue that one could view at least part of the payments and receipts to the Social Security system as "borrowing" and later as "loan repayments plus interest" rather than as "receipts" and "outlays" under the current terminology. Under one set of definitions, an increase in payments to the Social Security system would reduce the deficit. At the same time, under the alternative procedure, the payment would be borrowing, just like issuance of Treasury bonds, with no effect on the deficit. For reasons like these, Auerbach and Kotlikoff propose to deemphasize the conventional federal deficit measure in favor of a comprehensive system of financial flows for each age group in the population.

Auerbach and Kotlikoff have a point, but there is room for disagreement about the seriousness of this limitation to the conventional deficit measure and whether their alternative is better. Individuals whose spending is limited by the size of their paycheck are unlikely to view payroll taxes as equivalent to a financial investment. For them, it is primarily a tax and not an act of voluntary lending. As discussed below, because most available budget data convey very little information about the future, a system of generational accounts, or an alternative analytic framework, may be a

constructive addition even if one does not fully subscribe to Auerbach and Kotlikoffs criticism of the federal budget.

RESOURCE ALLOCATION: THE GOVERNMENTS CONTINGENT LIABILITIES

In addition to economic growth, the budget helps policymakers make decisions about allocating resources among different uses in the public and private sectors. Last year, the Omnibus Budget Reconciliation Act significantly improved the guidance that the budget offers regarding the longer-term consequences of federal credit programs for allocating resources. Now, CBO and others are working on similar changes in the budgetary treatment of another federal contingent liability program--deposit insurance.

Credit Reform

Analysts have long recognized that the conventional unified budget did not adequately treat the government's loan and loan guarantee programs, and the Omnibus Budget Reconciliation Act of 1990 provided for credit reform starting with fiscal year 1992. Before reform, government direct loans and loan guarantees providing comparable subsidies had very different effects on budgetary totals. For a direct loan program, the entire amount of the loan was shown as an outlay in the year in which it was disbursed. Repayment of

a loan showed up as an offset to budget outlays in later years. In contrast, the impact of a loan guarantee typically would not show up at all in the budget until future years, when defaults occurred.

Still more important, the old budgetary treatment completely concealed the subsidies that beneficiaries of both direct federal loans and loan guarantees draw from these programs over the long run. Federal credit programs carry subsidies by making credit available to their recipients on easier terms than would be available in the private sector. These subsidies represent the true impact of federal credit programs on the economy and on the allocation of resources.

Under credit reform in the recent Budget Enforcement Act, all direct government loans and loan guarantees will be analyzed to determine the present value of the government's subsidy over the entire life of the loan. The subsidy will be included as an outlay in the year in which the loans are disbursed. All other cash flows resulting from the credit programs will not affect the budget deficit.

This treatment for the government's loan and loan guarantee programs will be an improvement both in terms of the timing of their economic effects and in terms of budgetary control. The economic effects of these programs

are more closely associated with providing subsidies than with the cash flows as they occur over long periods. In addition, from a budgeting or financial control standpoint, it is appropriate to register the outlay when the loan is disbursed rather than when the secondary cash flows transpire. Finally, credit reform places both types of credit programs on a more comparable basis--a basis that also makes it more feasible to compare credit assistance with other programs or approaches.

Mandating credit reform and actually carrying it out are two different things, however. Credit reform stands a reasonable chance of succeeding. But in some cases, it will be difficult to estimate the subsidy, and plausible alternative methods may yield substantially different results. The new outlay estimates, however, should be far more appropriate than the old ones.

Deposit Insurance

The current budgetary treatment of federal deposit insurance suffers from many of the shortcomings of the old accounting for direct loans and guarantees. Federal contingent liabilities for deposit insurance typically arise much earlier than when cash payments are made--and long before the cost is first recognized in the budget. The federal liability to resolve a given insolvent bank or thrift institution accrues when that institution first goes under-not when the government's cash payment resolving that institution is

finally made. Moreover, many of the effects on allocating resources and the macroeconomy are felt when the public and financial institutions respond to the incentives deposit insurance provides.

The failure of cost to appear in the budget in a more timely manner has sometimes created the misleading impression that little or no cost was being incurred during certain periods, such as the mid-1980s. Now, the sudden appearance of bailout outlays, including funds for working capital, distorts the budget as a measure of the cost of current activities and events, and of the economic effects of the budget. That is the reason deposit insurance is excluded in one of the alternative definitions of the deficit in the budget outlook that I discussed earlier in my statement.

The Budget Enforcement Act of 1990 requires that both CBO and OMB do studies of the budgetary treatment of deposit insurance, in particular to consider whether "the accounting for federal deposit insurance programs should be on a cash basis, on the same basis as loan guarantees, or on a different basis." There are some parallels between loan guarantees and deposit insurance, but there are significant differences as well. Thus far, it is unclear whether a change in accounting for deposit insurance on the order of credit reform might be feasible and useful to budgeting. CBO is currently

working on a proposal for the budgetary treatment of deposit insurance, and expects that it will be included in the report which is due by the end of May.

Government-Sponsored Enterprises

The Budget Enforcement Act also calls on both CBO and the Treasury to complete by April 30th studies of the extent to which the federal government is exposed to loss from government-sponsored enterprises (GSEs), such as Fannie Mae, Freddie Mac, and FCS (Farm Credit System). Even though outstanding GSE obligations total over $950 billion at the end of calendar year 1990, our preliminary assessment suggests that the government's exposure is currently quite low, especially outside of the Farm Credit System. Nonetheless, it would be desirable to monitor the government's exposure to GSE risk, if only to give early warning of impending losses.

Social Security

Social Security (Old-Age, Survivors, and Disability Insurance) is in some respects a contingent budget liability. It is an entitlement program--anyone who meets the criteria for eligibility is entitled to benefits. Although future benefits are not "contractual," in the sense of being legally binding, it is useful

to think of each year that passes as having created a claim on future government resources.

Isolating the Operations of the Social Security Trust Funds. The Budget Enforcement Act excludes the receipts and spending of the Social Security trust funds (as well as the Postal Service) from all calculations under the Balanced Budget Act; in one respect, this separation clarifies the longer-run situation. (The deficit after these exclusions and assuming the discretionary caps on spending is referred to as the "on-budget deficit.") Under current policies, the receipts to the Social Security trust fund plus interest on trust fund balances will significantly exceed the outlays for pensions until approximately 2020, after which the reverse will occur, and the trust fund balances will be exhausted around the middle of the century.

From the standpoint of economic policy, however, the on-budget deficit is not meaningful because the flows in Social Security (and the Postal Service) affect economic activity and the allocation of resources in the same way as the flows in other government accounts. The total government deficit, including Social Security, determines the government's drain on credit markets, and the amount of saving that it diverts from uses that promote growth in living standards. Therefore, CBO continues to present projections for the total

deficit and the total deficit less deposit insurance, as well as for the "on-budget" deficit.

Long-Term Social Security Projections. For a number of years, the Social Security Administration has routinely made 75-year projections of Social Security contributions and expenditures. It has also estimated the present value of contributions and expenditures. The estimates of present value are useful in assessing whether the system is approximately self-financing over the 75-year horizon.

Long-Run Social Security Issues. The availability of long-term Social Security projections has dovetailed effectively with the development and use of long-run macroeconomic models. CBO now uses these budgetary data along with several long-run models to analyze the effects of policy changes particularly on economic growth.

I would like to indicate the kinds of Social Security issues that can be analyzed within this framework, and the advantages and limitations of this analysis. Many of the current proposals involving Social Security would lower the burden of the payroll tax on current wage earners while raising the burden on wage earners in the twenty-first century, when the ratio of retirees to workers will have increased substantially. Enacting such proposals would

eliminate the surplus in the Social Security accounts that is being generated under current law. With the help of long-run economic models, long-term Social Security projections help answer the basic question: what is the effect of having a large surplus in the system now, and how will things be changed if the buildup in the trust fund does not take place?

The most important channel through which these changes in funding would affect the overall economy is through their effects on the total budget deficit and thereby on national saving. Our techniques for long-run analysis tell us that if the current Social Security payroll tax rate were reduced by roughly two percentage points, and if no changes in other programs were made to keep the overall deficit the same, realGNP would be perhaps one-half percent lower around the turn of the century than it otherwise would be. This result stems from the reduced national saving and investment caused by the payroll tax reduction. If the changes in the deficit caused by modification in the funding of Social Security were offset by adjustments in other taxes or changes in government expenditures, however, the overall macroeconomic effects would be slight.

Analyzing such changes in Social Security policy also raises a number of important equity issues. Questions of equity among generations arise prominently since currently working generations would gain at the expense of

later generations if the payroll tax were first reduced and then raised later as the retirement burden grows. In addition, issues of equity among classes of current taxpayers arise, since Social Security taxes are more regressive than most other major federal taxes.

DISTRIBUTIONAL ISSUES: GENERATIONAL ACCOUNTING

In addition to economic growth and the allocation of resources, the budget helps policymakers make decisions concerning the distribution of income among different groups. We are all aware of the intense interest that sometimes attaches to questions about the impact of the budget or the tax system on the fortunes of people at different points on the income spectrum. More recently, however, interest has begun to focus on another aspect--the budget's impact on the well-being of different generations.

Much of the anxiety that attaches to the budget deficit is motivated by a vague concern that it represents a burden on later generations. In recent years, economists have been developing several models that are useful in analyzing this kind of issue. For instance, Don Fullerton of the University of Virginia and Diane Rogers of Pennsylvania State University have developed a long-run model that focuses on key microeconomic behavior such as saving,

investment, and work--a type of model referred to as a "dynamic general equilibrium model." Alan Auerbach and Laurence Kotlikoff have developed another approach called "generational accounting." I will focus my discussion on this latter approach because you have requested that CBO examine it.

The system of generational accounts, proposed by Auerbach and Kotlikoff (A-K), is intended to be explicit and precise about the net burdens that government policies, if extended indefinitely, impose on different age groups, including the unborn. Generational accounts indicate, in terms of present value, the net amount that current and future generations are projected to pay to the government now and in the future. This system would also provide a framework for evaluating the effects on different generations of particular fiscal measures, such as last fall's landmark budget agreement.

I will not go into a detailed explanation of the system or comment extensively on its advantages and disadvantages, since the architects of that system are scheduled to appear before the Subcommittee and CBO is in the midst of a detailed analysis of the A-K model. As you requested in your letter of February 19, CBO is assessing the possibilities of carrying out a system of generational accounts of the kind proposed by Auerbach and Kotlikoff. This type of undertaking is complex and detailed, and will take some time to complete. We are currently getting A-K's computer program,

running it, and learning its nuts and bolts. Among the aspects that we are examining is the sensitivity of the results to different assumptions that are needed for the model. The A-K framework requires a relatively large number of assumptions about the distant future. Moreover, to a large extent, the results of the analysis are only as good as the assumptions. Thus, it is crucial to learn more about the sensitivity of the results to alternative assumptions. Particularly in the early stages of this work, it will be important not to attach too much weight to the results simply because they are quantitative and have the appearance of precision.

One of the problems in settling the question of what kind of burden current government policies impose on future taxpayers is deciding exactly what is the current policy commitment to future spending. Social Security is the easiest case because the benefits to be paid in the future are spelled out in a formula in the law. But in the case of food stamps, for example, it is not so clear what current policy implies for the future. A plausible case could be made for projecting expenditures on food stamps based on the program's current formula adjusted for inflation only, or for holding food stamps as a constant share of the incomes of the poverty population, and so on. We suspect that these plausible interpretations of current law would produce very different answers, but we have not done the detailed work yet. Similar vexing

questions about the meaning of current policy in the context of long-run projections arise on the tax side of the ledger as well.

In addition, the generational accounting approach in and of itself does not include some important feedbacks between fiscal policy and national economic growth. For example, the recent fiscal actions taken in the Budget Act of 1990 to reduce the government's dissaving and increase national saving should increase long-run economic growth, but that type of feedback is not incorporated in A-K's current framework.

Generational accounting and related work are useful supplements to more conventional budget measures in some cases, but questions arise about how extensively they can be used. Distributional analysis of this kind seems unlikely to become a routine part of the budget analysis for typical bills because it involves time-consuming analysis of large volumes of detailed information, along with many somewhat arbitrary assumptions. Providing timely estimates of budget impacts that can be explained and defended is often a key consideration. In addition, the distributional consequences of some policy proposals may be trivial relative to other considerations, or to the errors that are inherent in the estimates. Moreover, the type of distributional analysis of interest to policymakers tends to vary with the program or issue. For instance, primary concern for some issues in tax policy may center on the

impacts on income distribution of the current generation, such as between income groups or between wage earners and other taxpayers. But generational analysis would shed no new light on these conventional issues of income distribution.

Finally, it may be difficult to interpret the results of generational accounting. Traditionally, it has been argued that it may be all right to do some shifting of burdens from present to future generations because future generations benefit from economic growth. But how much shifting is too much? This is basically a question of politics, not economics.

CONCLUSION

Considerable progress has been made in developing budget information for longer-run decisionmaking, but major problems and limitations of existing information remain. Providing information about the medium-run implications of policies on the budget was one of the main reasons for establishing CBO. However, more information on the longer-run implications of programs and policies and on their comprehensive effects on different groups might be useful.

The federal deficit, imperfect as it is, conveys important information about the long-run effects of budget policies on national saving and economic growth. As with any simplified measure of complex phenomena, one can make a number of adjustments to the deficit, such as for the effects of inflation on the real value of the national debt. However, such adjustments are often not critical to the interpretation. In other words, the adjusted deficit series usually tells the same story as the unadjusted deficit series.

In contrast, conventional budget data convey little information about some other long-run issues, and that has proved to be critical in the case of the government's contingent liabilities. Contingent liabilities have been, and will remain, the focus of much work at CBO and elsewhere. Credit reform promises to be a major advance in making available budget information about the longer-run consequences of policies. However, serious problems in the treatment of deposit insurance remain.

Comprehensiveandforward-lookingframeworks,suchasgenerational accounting and other long-range models, might fill an important type of information gap that currently exists, and these approaches merit careful consideration. CBO is now in the process of examining thoroughly the Auerbach-Kotlikoff model, and will report the results to you as soon as we

can. We expect this to be part of our ongoing analysis of alternative methods of assessing the long-run consequences of fiscal policy.