CBO TESTIMONY

Statement of
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before the
Subcommittee on Economic Stabilization
Committee on Banking, Finance and Urban Affairs
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NOTICE

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Mr. Chairman and members of the Subcommittee on Economic Stabilization, I appreciate the opportunity to appear here this morning to discuss the budget outlook, how budget deficits affect long-term economic growth, and the role of the deficit in the current economic downturn.

The Congressional Budget Office (CBO) and most economists have concluded that persistent federal deficits of the sort this country has experienced for over a decade dampen the rate of productivity and economic growth. Ultimately, the large deficits 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 are occurring 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.

Federal fiscal policy could partially counteract these long-term developments. A fiscal policy designed to spur investment and saving, both through a reduction in federal borrowing and through properly tailored spending and taxation policies, could provide an important boost to long-term growth. Among these policies, decisions about the size of the deficit and about government's direct spending on investment are likely to have the largest impact on growth. Changes in incentives through tax policy for private saving and investment are less important.

Excluding deposit insurance, the deficit is expected to fall from 5.3 percent of gross domestic product (GDP) in 1992 to 3.1 percent in 1996. The bulk of the drop in the deficit stems from the projected recovery from the recession, however. A more useful measure of the deficit for long-run trends is the deficit adjusted for the effects of the business cycle--the standardized-employment deficit.

In the CBO baseline projection, the standardized-employment budget deficit (excluding deposit insurance) declines to 2.5 percent of potential GDP by 1995, but it rises thereafter to about 4 percent in 2002 (see Table 1 and Figure 1). 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.

The increase in the deficit as a share of GDP in the long run stems from the rising share of outlays. Revenues remain at about 19 percent of GDP throughout the projection period, but outlays climb from 22.0 percent of GDP in 1997 to 23.3 percent in 2002. As a share of GDP, the government's big health care programs rise rapidly, whereas discretionary programs--

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	273	311	345	385	432
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	3.3	3.5	3.7	4.0	4.2
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

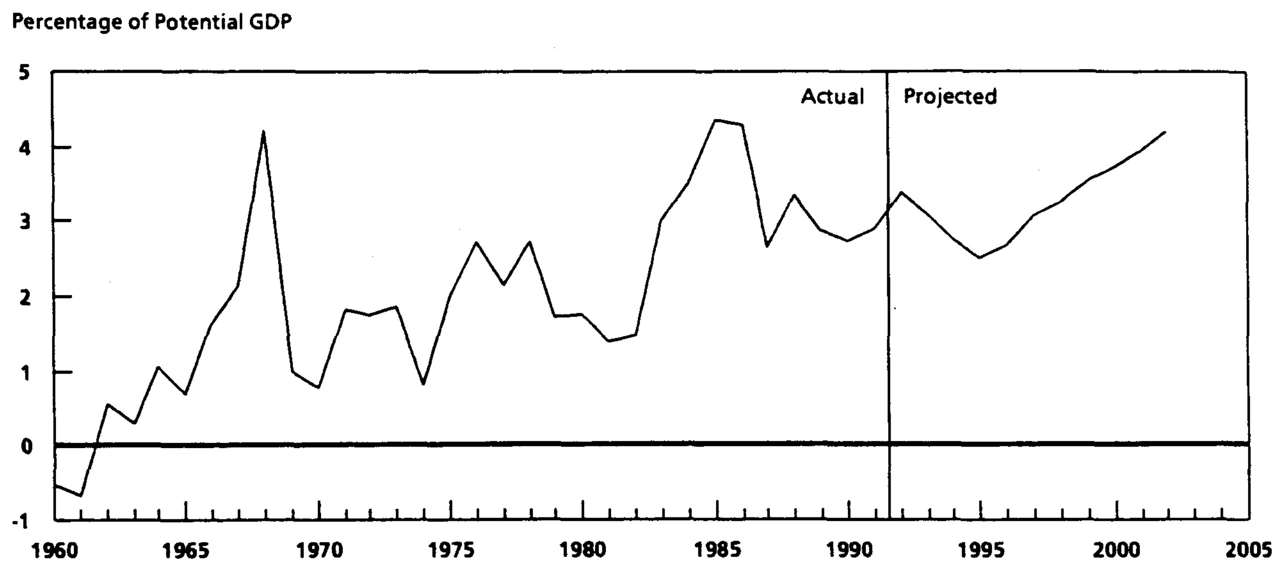
SOURCE: Congressional Budget Office (March 1992).

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 Deficit



SOURCE: Congressional Budget Office.

defense, international, and domestic--gradually decline. 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 within the period. Benefits, however, will begin to rise rapidly a few years after 2002 because of the large demands of the baby-boom generation.

Even though total spending rises rapidly in the projections, these projections incorporate the severe restraints imposed on discretionary spending through 1995 by the Budget Enforcement Act. If these limits are not adhered to, deficits would be greater than the baseline projection indicates.

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

These projections, of course, would be changed by any new legislation. But they are also subject to other kinds of uncertainty, particularly that connected with the economic outlook. To give some idea of the size of the uncertainty associated with the economic projection, CBO calculations

indicate that there is a 67 percent chance that, as a share of GDP, the actual deficit will be within 1.9 percentage points above or below the 4.2 percent of GDP in the baseline.[1] Thus there is only about a 17 percent chance that the deficit, under current policies, could drop below 2.3 percent by 2002. Conversely, there is a similar chance that the deficit could exceed 6.1 percent of GDP by 2002 under current policies.

HOW DO DEFICITS AFFECT FUTURE LIVING STANDARDS?

If the deficit follows the projections in Table 1, fiscal policy will be hampering the growth of living standards, and it will be doing so at a time when other developments are also raising concerns about long-term growth. The argument for deficit reduction maintains, first, that the net national saving rate and investment will increase and, second, that the higher level of investment will ultimately promote a higher standard of living.

1. See Congressional Budget Office, "Economic Uncertainty in Ten-Year Projections," letter to Senator Pete V. Domenici, October 28, 1991.

Effect of the Deficit on Saving and Investment

The first part of the argument in favor of reducing the deficit is that it will increase the net national saving rate and investment in the long term. From an accounting point of view, any reduction in the deficit is a reduction in government dissaving and, therefore, an increase in national saving and investment. Some analysts are concerned, however, that the private saving rate might fall sharply in response to increases in the federal saving rate and in so doing largely offset the beneficial effect of a falling deficit. This question has not been totally resolved. Studies indicate, however, that a reduction in the deficit of one dollar tends to reduce private saving on the order of 20 cents to 40 cents, implying that national saving and investment are increased by 60 cents to 80 cents for every dollar of deficit reduction.[2]

2. 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.

Effect of Saving and Investment on Economic Growth and Living Standards

The second part of the argument for deficit reduction is that an increase in net investment will significantly raise the rate of economic growth.[3] There is general agreement that investment will increase the growth of labor productivity and increase the long-term growth rate, but the magnitude of the effect on growth is uncertain. In studying this issue, economists have found that the approach based on the growth-accounting framework imputes a modest degree of importance to the effect that changes in investment have on increasing growth. Other approaches, however, such as cross-country empirical studies and the new growth theory, imply that investment can be more effective in raising the growth rate.

The growth-accounting approach, which is more widely accepted than the alternative approaches, indicates that a permanent reduction of 2 percentage points in the deficit relative to GDP raises living standards 50 years hence by about 2 percent. The more optimistic alternative theories imply a 14 percent increase in the level of living standards for every reduction of 2 percentage points in the deficit.

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3. See "Implications of Federal Deficits for Economic Growth," pp. 79-99 in Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1990-1994* (January 1989).

Other Concerns About Long-Term Growth

The current deficits are occurring in the midst of three other important developments that have raised concerns about the future in their own right:

- Private-sector saving rates have been much lower in the last 10 years than in the previous 35 years, and it is unlikely that the private saving rate will rise rapidly in the near future.

- The trend growth in productivity has been much slower in the period since 1973 than in the preceding 25 years.

- A smaller percentage of the population is likely to be in the labor force in 15 or 20 years than is in the labor force today.

Both lower private-sector saving rates and the lower growth in productivity mean that real output per worker will grow slowly in the future. Moreover, each worker in the future will have to support more nonworkers than is the case today. Clearly, these developments together raise the

possibility of very slow growth in consumption per capita, that is, a slow growth in living standards.

HOW DIFFICULT WILL DEFICIT REDUCTION BE?

Deficit reduction has obviously been extremely difficult to accomplish. The persistence of high standardized-employment deficits in the wake of the conscientious effort to reduce deficits in the 1990 Omnibus Budget Reconciliation Act underscores the magnitude of the problem.

Can We Grow Our Way Out of the Problem?

As the previous discussion of the uncertainty surrounding the estimates indicates, policymakers should not count on the possibility that the deficit might shrink significantly by virtue of economic growth alone. Since even rather optimistic economic assumptions reduce the deficit's share of GDP only to 2.3 percent by 2002, and since much larger deficits are equally likely, the chances of "growing our way out" are small.

The Peace Dividend

If we cannot rely on growing out of the deficit problem, then can we hope that the huge changes in the former Soviet Union, which have greatly reduced the military threats we face, will give us an easy way to cut the deficit? Unfortunately, we cannot. Because the 1990 budget agreement's restrictions on military and other discretionary spending are so tight, a large peace dividend is already assumed in the budget projections and a further peace dividend cannot be counted on for an easy route to deficit reduction. To achieve the reductions in discretionary spending required by the agreement and incorporated in the projections will almost certainly require further substantial cuts in the defense budget. Defense would have to be cut just to spare domestic discretionary programs from real reductions.[4]

Budgetary Costs of Medical Care

The major remaining portion of the budget--entitlements--has proved very difficult to control. A large part of the reason is the growing costs of health care. Direct federal health expenditures, which accounted for 16.6 percent of total outlays in 1991, are projected to increase to 26 percent of outlays by

4. See Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1993-1997* (January 1992), pp. 52-54.

2000. Several proposals have been made for reforming the health care system to contain its costs, but there could also be upward pressure on federal health care spending from the push to provide better access to those people who are currently underinsured.

Deficit Reduction Need Not Cause Severe Hardship

Although it will be difficult to reduce deficits, the short-run hardship can be minimized by the proper use of fiscal and monetary policy. Monetary policy can offset much of the short-run contractionary effect of deficit reduction, particularly if the reduction is carried out in a credible and consistent way. The more stable and predictable the path of deficit reduction, the more likely the economy will be able to adjust to the reduction with relatively small short-run costs.

IS THE DEFICIT ALL THAT MATTERS FOR GROWTH?

The task of reducing the deficit will be difficult. But the federal deficit is only one way in which federal fiscal policy can affect growth. 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 important as private investment in generating growth--and at the effects of tax policy on the incentives from private saving and investment.[5] Unfortunately, broadening the view does not improve the outlook.

Federal Investment Spending

Rising federal deficits would not affect growth if they financed productive investments in such things as infrastructure and education. Education is an important factor in growth. 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, through not by the federal government. In the past, some federal infrastructure has been about as successful as private investment at 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.

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

But the current and projected federal deficits do not reflect increased investment spending. It is difficult to determine exactly which categories of federal spending should be classified as investment, but federal investment as a share of 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

Tax policy also has implications for future living standards beyond the direct effect of taxes on the deficit. It is hard to estimate the quantitative effects of changes in tax incentives, but the net effect is unlikely to be significant compared with the effect of the deficit itself.

The primary influence of changes in tax law, other than their effect on the total deficit, are their microeconomic effects on economic efficiency and on decisions about saving, investment, and work effort. Two important microeconomic aspects of taxation that affect long-term living standards are (1) the extent to which consumption is taxed relative to saving, and (2) whether the marginal rates are so high that they discourage people from working or significantly distort economic decisions (in general, economic decisions are least likely to be distorted if the tax has a broad base).

The implications of tax changes for growth are obviously important considerations of tax policy, though equity and other criteria are also important. Policymakers should consider taxes that encourage more saving, such as consumption-based taxes, and clearly they should be aware of the incentive effects of new tax laws. In the end, however, the effects of taxation on future living standards are small relative to the effect of the federal deficit.

THE STANDARDIZED-EMPLOYMENT DEFICIT AND THE CURRENT ECONOMIC DOWNTURN

Although the most important effects of persistent standardized-employment deficits occur in the long run, the deficits may have had some adverse effects in the short run as well. The chronic deficits of the 1980s were not a direct cause of the current economic downturn, but they helped create an environment that made the recession more likely.

Antirecession Fiscal Policy

Discretionary fiscal policy has been less expansionary in this recession than in the average recession. The absence of a more aggressive stimulus early in the recession is understandable. Economists failed to forecast the duration of the

economic slowdown, and many feared any stimulus would have come too late. In addition, policymakers were concerned about exacerbating the deficit and about the constraints of the Budget Enforcement Act.

If the deficit had been small before the recession, the advisability of short-run stimulus would not have been weighed against concerns about the long-run deficit, and it would have been easier to decide in favor of a stimulus package early on. The chronic deficits of the 1980s have also weakened countercyclical policy by heightening the sensitivity of financial markets to the prospects of larger standardized-employment deficits. Long-term interest rates appear more likely to rise significantly when fiscal stimulus is proposed, therefore curtailing more of the potential stimulus than if chronic deficits were not a problem.

The Deficit and the Effort to Resolve the Savings and Loan Problem

Timely closure of failed thrift institutions would have reduced the cost of the savings and loan problem, but it was postponed in part because of concern over the deficit. Even though the magnitude of the problem was still uncertain in the mid-1980s, policymakers did not address the problem immediately for a number of reasons. Prominent among these reasons for

delaying closure was the sheer magnitude of the budget deficit. The Federal Savings and Loan Insurance Corporation, the agency that insured deposits at thrifts, did not have sufficient cash resources to deal with all insolvent or failing thrifts. Timely resolution of failed thrifts would have entailed significantly enlarging the deficit, an unpalatable prospect under any circumstances, but particularly so under the budgetary requirements of the Balanced Budget and Emergency Deficit Control Act of 1985 (commonly known as Gramm-Rudman-Hollings). Under that act, other spending would have to be reduced if spending for resolving thrifts rose, even though most of the thrift spending was for temporary working capital. The failure to resolve the thrift problem expeditiously helped create structural imbalances in the financial sector--causing more thrifts to fail--and in real estate, and it may have contributed to the development of imbalances in other sectors of the economy as well. A major consequence of the thrift crisis was a misallocation of credit. These imbalances, in turn, have been cited as contributing factors both for the onset of the recession and its persistence.

Interest Rates, Deficit Uncertainty, and Monetary Policy

The chronic deficits of the 1980s contributed to higher real interest rates. The higher rates, together with uncertainty about future fiscal policy and future deficits, complicated monetary policy's efforts to stabilize the economy.

The large deficits tended to raise inflation-adjusted interest rates by reducing the pool of funds available for loans to the private sector. Given the normal growth in opportunities for profitable investment, the fall in the net national saving rate--a fall that stemmed from both the increase in the deficit and a drop in the private-sector saving rate--resulted in a competition for scarce funds for loans, which in turn drove up inflation-adjusted interest rates.

The deficits probably also contributed indirectly to higher interest rates because of their role, mentioned above, in delaying the closing of thrift institutions. The insolvent, but operating, thrifts offered depositors high interest rates in order to finance their gamble for recovery, and this action probably helped lift the whole structure of interest rates during the 1980s.

The high rates that persisted through the 1980s had a number of destabilizing consequences: they made it more difficult for some financial institutions to adapt to changes in the regulatory environment, they hindered

investment planning, and they encouraged large inflows of foreign capital. In the early 1980s, the capital inflows caused the value of the dollar to increase rapidly for a few years, which in turn caused net exports (in constant dollars) to decline through the mid-1980s.

Uncertainty about future deficits also complicated the task of stabilizing the economy. In particular, the prolonged negotiations that preceded the Omnibus Budget Reconciliation Act of 1990 appear to have made the Federal Reserve reluctant to ease monetary policy until after the fiscal outlook clarified. Unfortunately, the budget negotiation period coincided with the early stages of the recession (though that was not generally recognized at the time), and postponing the monetary easing may have exacerbated the recession.

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, growth in labor productivity, and overall economic growth have been adversely affected by the persistent standardized-employment deficits of the 1980s, and there is no relief in sight. Policy changes can partially reverse

the slowing of growth, but these changes will be difficult to make and may entail a short-run sacrifice of living standards for the sake of higher living standards in the future.

The initial sacrifice could be reduced, however, with the proper use of fiscal and monetary policy. A credible and consistent long-run deficit reduction policy, when combined with an easier monetary policy, would minimize the adverse short-run effects of deficit reduction.

The chronic deficits have also complicated the task of stabilizing the economy and were an indirect cause of the current economic slowdown. The persistent deficits ultimately fostered economic imbalances that increased the likelihood of a recession.