

Statement of
Rudolph G. Penner
Director
Congressional Budget Office

before the
Committee on Ways and Means
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NOTICE

This statement is not available for public release until it is delivered at 11:00 **a.m.** (EST), on Wednesday, February 4, 1987.

Mr. Chairman, it is a pleasure to appear before this Committee to discuss the economic and budget projections, along with deficit reduction options of the Congressional Budget Office (CBO). The projections are described in detail in the CBO report titled *The Economic and Budget Outlook: Fiscal Years 1988-1992*, which was released last week. Today, we are releasing the 1987 version of *Reducing the Deficit: Spending and Revenue Options*. In my testimony this **morning**, I will discuss:

- o The economic forecast for 1987 and 1988, and projections for 1989-1992;
- o The CBO baseline budget projection; and
- o Deficit reduction options.

CBO'S ECONOMIC AND BUDGET PROJECTIONS

The Congressional Budget Office projects that, under current taxing and spending policies, the federal deficit will decline from its record high of \$221 billion in 1986 to \$174 billion in 1987, \$169 billion in 1988, and \$85 billion in 1992. In relation to gross national product (GNP), the deficit is projected to decline from 5.3 percent of GNP in 1986 to 3.6 percent in 1988 and 1.4 percent in **1992**.

These budget projections are contingent on CBO's forecast of a moderate pickup in economic growth from its subdued pace in 1986, and a modest decline in both short-term and long-term interest rates over the projection period from their average levels in 1986. They also assume that

both defense and nondefense discretionary appropriations are held to zero real growth. The budgetary outlook and the economic assumptions underlying the forecast are presented in Table 1.

The economic expansion has now entered its fifth year. Over the four quarters of 1986, the economy grew at a **2½** percent **rate--about** the same as in 1985 but substantially below its growth in the first two years of recovery. Unemployment in 1986 was slightly below that of 1985 but still averaged 7.0 percent. Total employment grew rapidly, however, by about 2.3 percent. Most of the new jobs were in the service-producing sector. Growth in employment in the goods-producing sector continued to be weak, which is at least partially attributable to the widening trade deficit. The trade deficit was, in turn, partly the result of the high budget deficit. The latter has necessitated a large amount of borrowing from abroad, which has pushed up the value of the dollar until recently and made it more difficult for U.S. producers to compete with foreigners.

Inflation decreased in 1986, especially as measured by the Consumer Price Index (**CPI**), largely because of the precipitous decline in oil prices at the beginning of the year. Despite the continuing depreciation of the dollar against most other currencies, prices of imports did not move up as sharply as many forecasters had anticipated, nor did the import surplus decline as had been expected. Interest **rates--especially** long-term rates-fell considerably as a result of the easing of inflation, the sluggish growth of the economy, and the expectation of lower federal deficits.

TABLE 1. BASELINE BUDGET PROJECTIONS, DEFICIT TARGETS,
AND UNDERLYING ECONOMIC ASSUMPTIONS

	<u>Actual</u> 1986 <u>a/</u>	1987	1988	1989	1990	1991	1992
Budget Projections (By fiscal year, in billions of dollars) <u>b/</u>							
Baseline Estimates							
Revenues	769	834	900	962	1,050	1,138	1,220
Outlays	990	1,008	1,069	1,124	1,184	1,247	1,305
Deficit	221	174	169	162	134	109	85
Deficit Targets	172	144	108	72	36	0	n.a.
Baseline Less Targets	49	30	61	90	98	109	n.a.
Economic Assumptions (By calendar year)							
Nominal GNP (percent change)	5.4	6.0	6.9	7.2	7.4	7.0	6.8
Real GNP (percent change)	2.6	2.8	3.0	3.0	3.1	2.7	2.5
CPI-W (percent change)	1.6	3.5	4.3	4.3	4.3	4.3	4.3
Civilian Unemploy- ment Rate (percent)	7.0	6.6	6.5	6.3	6.1	6.0	6.0
Three-Month Treasury Bill Rate (percent)	6.0	5.6	5.7	5.6	5.5	5.3	5.2

SOURCE: Congressional Budget Office

NOTE: n.a. = not applicable.

- a. 1986 data for nominal and real GNP and the CPI-W are CBO estimates. The estimates do not reflect the actual data for the fourth quarter of 1986 that were released on January 22, 1987.
- b. The baseline estimates and deficit targets include Social Security, which is off-budget.

CBO forecasts a moderate pickup in economic activity in 1987 and 1988. Real GNP is expected to grow just under 3 percent annually, which should bring unemployment down to an average of 6.6 percent in 1987 and 6.5 percent in 1988. Like most other **forecasters**, CBO anticipates that the trade sector will be the major contributor to the stronger growth.

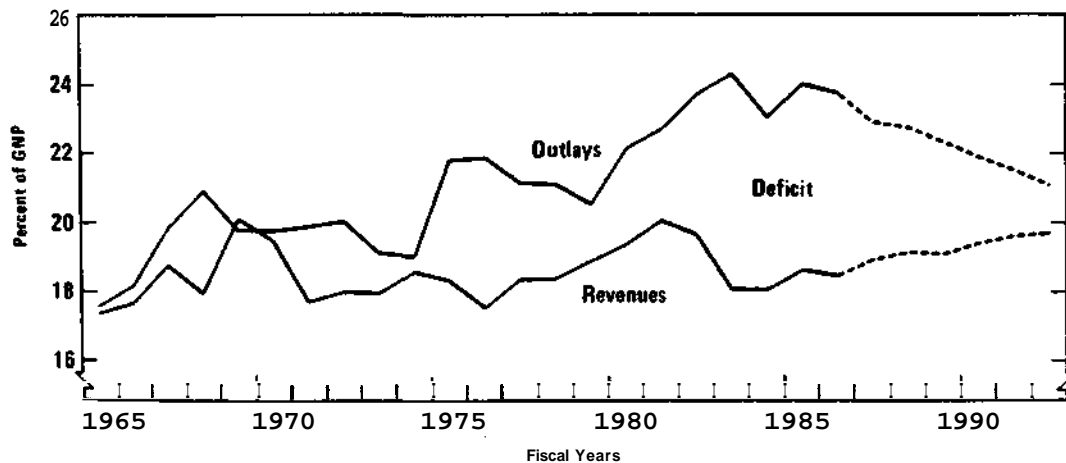
CBO's forecast calls for a rise in reported inflation, between 2 percent and **2½** percent in 1986 (as measured by the implicit GNP deflator) to about 3.7 percent in 1987-1988. On the consumer level, CBO sees inflation rising even more **sharply--from** the artificially depressed rate of about **1½** percent in 1986 to almost **4½** percent in 1987 and 1988. The rise in inflation will reflect, among other things, somewhat higher oil prices and rising import prices caused by the falling dollar. Nominal interest rates in 1987 and 1988 are expected to stay at about their present levels.

Under these economic assumptions, CBO projects a sharp decline of the baseline budget deficit in 1987 and a further moderate reduction in 1988. About half of the expected decline in the 1987 deficit results from one-time factors, including an increase in revenues under the Tax Reform Act of 1986, asset sales, and shifts of outlays into adjacent years. After 1987, revenues under current laws are projected to grow at an annual rate of nearly **8 percent--slightly** faster than **GNP--while** baseline outlays grow only 5 percent per year, which is substantially below the 10 percent annual growth rate experienced earlier in the 1980s and less than the projected growth in the economy (see Figure 1).

Figure 2 summarizes recent trends and the CBO baseline projections for the major categories of federal spending. Nondefense discretionary spending has been curbed most **sharply**, falling from 5.8 percent of GNP in 1980 to 3.8 percent in 1987. Spending for national defense was fed by sharp real growth in appropriations in the early 1980s, followed by small real cuts in the last two years. These cuts and the CBO baseline assumption of zero real growth in budget authority would put the defense share of GNP on a downward trend over the next five years. Under current law, entitlement spending should remain at a steady share of slightly below 11 percent of

FIGURE 1.

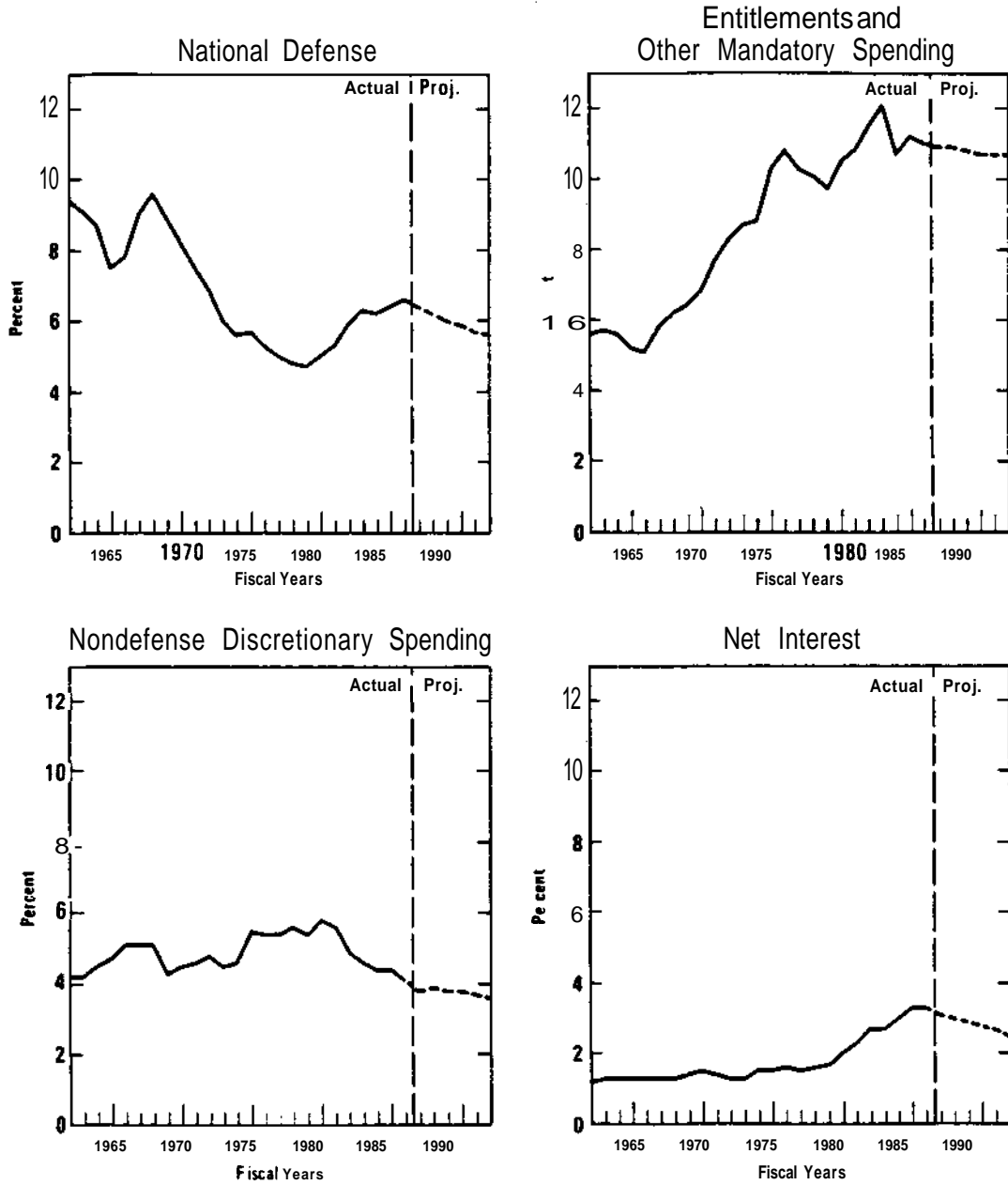
Baseline Revenues and Outlays



SOURCES: Congressional Budget Office; Office of Management and Budget; Department of Commerce, Bureau of Economic Analysis.

FIGURE 2.

Outlays by Category as Percents of GNP



SOURCE Congressional Budget Office

GNP through 1992, although that category includes agricultural price **sup-ports**, a notoriously difficult program to project. Price support spending has tripled in the last decade, and will continue to be **affected** by the weather and by foreign developments. Finally, net interest spending driven up first by rising interest rates and then by rising deficits should begin to fall as a share of GNP as these two factors are reversed. Any deficit reduction plan would most probably earn a bonus in the form of lower interest costs.

DEFICIT REDUCTION OPTIONS _____

Baseline budget deficits, although declining throughout the projection period, exceed by large amounts the targets established by the Balanced Budget Act. The 1988 deficit would have to be cut \$61 billion below the baseline in order to reach the goal of \$108 billion. For fiscal years 1989 through **1991**, the baseline deficit averages about **\$100** billion over the statutory targets (see Table 1).

Unless the target deficits under the Balanced Budget Act are amended, the budget resolution for 1988 will require the Congress to make exceedingly difficult choices to achieve reductions from baseline spending and additions to revenues. The 1987 version of CBO's annual volume entitled *Reducing the Deficit: Spending and Revenue Options* discusses these alternatives.

Spending Reduction Options

Making a major dent in the excess deficit by reducing government spending can, in theory, be accomplished in an infinite variety of ways. CBO's *Reducing the Deficit* volume attempts to present balanced, brief discussions of spending reduction options. We have divided spending into five major categories for this purpose.

- o National Defense
- o Entitlements Other Than Farm Programs
- o Nondefense Discretionary
- o Agricultural Price Supports
- o Federal Work Force

National Defense. This area of the budget supports developing and procuring equipment for the armed forces and paying personnel to operate and support their equipment. Budgetary savings for 1988 in national defense could be achieved in a variety of ways. Our report offers illustrative proposals for achieving savings in both investment spending and operation and support spending. Options for investment spending range from canceling major procurement items, such as the **C-17** transport aircraft, to slowing production of programs like the Trident submarine and the MX missile. In the operating and support area, proposals range from limiting military pay to reducing the number of active-duty military personnel.

Entitlements Other Than Farm Programs. Social Security and Medicare are the two largest entitlement programs, representing almost two-thirds of **nonfarm** entitlement spending in 1986. The remaining one-third of this

category consists of other non-means-tested programs such as Unemployment Insurance (UI) and means-tested ones such as Medicaid. *Reducing the Deficit* includes 13 options that would slow the growth in spending for health programs, which has risen faster than outlays for nonhealth entitlements. Medicare is emphasized because it accounts for almost three-quarters of health spending in this category. Some of the alternatives would reduce payments to providers of health-care services, including revising payment rates for hospitals under the prospective payment system and introducing a fee schedule for physicians. Other options would raise receipts either by requiring that beneficiaries pay more or by increasing revenues from broad groups of taxpayers. The study also includes eight ways of modifying nonhealth entitlements that would cut the deficit. For example, the Congress could limit **cost-of-living** adjustments in Social Security and other non-means-tested programs or could change the benefit or revenue provisions of Unemployment Insurance.

Nondefense Discretionary Spending. About **one-third** of the spending on these programs provides individuals with benefits or services such as housing and education. Another **one-fifth** is spent on infrastructure systems such as transportation and water resources. The largest **share--45 percent--is** spread across diverse programs promoting business and commerce, civilian research and development, energy and natural resource development, aid to foreign governments and international organizations, and general government functions.

Budgetary savings in these programs could be achieved in a variety of ways described in this report. For example, education programs could be more stringently targeted toward students with financial or other special needs. Other options would increase the reliance on user fees and state and local **resources**, while improving the efficiency of transportation, water resources, the postal service, and other programs providing marketable services to private individuals. Savings could also arise by curtailing programs with uncertain or distant **benefits--such** as space **exploration--or** by reducing or redesigning programs where needs have **changed--such** as energy development.

Agricultural Price Supports. Federal spending on agriculture is dominated by supports for commodity prices and farm incomes. Such spending could be reduced while maintaining the current policy framework by further lowering target prices for supported crops or by allowing the Secretary of Agriculture to require farmers to idle more land as a quid pro quo for program benefits. A third option would restrict the ability of farmers to use generic commodity certificates (an innovation introduced in the 1985 farm bill) to repay their nonrecourse loans at prices below support levels. Alternatively, farmers in the most serious financial condition could be targeted for greater assistance, while commodity target prices are cut across the board for all farmers and crops.

The burden of supporting domestic agriculture could be shifted from the government to consumers by mandating reductions in crop supplies in order to raise crop prices. Finally, the current system of price and income supports could be replaced with direct grants to farmers that would be unrelated to their production and that would be phased out over time. This "decoupling" would support farm incomes for an interim period and allow crops to be produced and sold on their own economic merits.

Federal Work Force. Higher spending projected for this category derives mainly from pay increases and from the growth in retirement benefits received by former federal employees and their families. Reducing payroll costs, as indicated in two of the report's options, would require either curtailing the number of federal employees or changing the timing and size of government pay raises. The other options included in this section would lower health-care premiums for federal workers and their employing agencies, limit government travel expenditures, and restrict COLA payments for nondisabled federal retirees until they reach age 62.

Revenue-Raising Options

The Ways and Means Committee has just completed the herculean task of reforming our income tax system. This effort has reduced the number of loophole-closing options available for our report. Some opportunities for base broadening remain, however, and they are included. Outside of the

income tax system, our report discusses a variety of excise tax increases (on energy, and so forth) and a value-added tax.

Since this is my last appearance as CBO director before this Committee, I would like to express my appreciation for the excellent relationship between CBO and the Ways and Means Committee and its staff. You have been one of our best customers, and I have enjoyed working with you.