

CBO TESTIMONY

Statement of
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before the
Task Force on Budget Process,
Reconciliation, and Enforcement
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Mr. Chairman and members of the task force, thank you for inviting me to participate in your review of the Budget Enforcement Act of 1990. In my view, the discretionary spending Emits and pay-as-you-go regime established last year are making an important contribution to controlling the federal deficit. But large budget deficits continue to be a major obstacle to raising living standards and expanding opportunities. Sooner or later the Administration and the Congress should take further steps to reduce the deficit. Any revisions to the Budget Enforcement Act should be designed to contribute to that goal.

My statement will first examine proposals to reallocate funds among the three categories of discretionary spending for 1993. I will then summarize the current outlook for the deficit and review the reasons that additional deficit reduction is needed. In conclusion, I will discuss some ideas for modifying the Budget Enforcement Act.

SHOULD THE CAPS BE ADJUSTED?

For 1991 through 1993, the Budget Enforcement Act (BEA) established separate budget authority and outlay limits for defense, international, and domestic discretionary spending. For 1994 and 1995, however, budget authority and outlay caps are set for discretionary spending as a whole. Two factors are causing a reassessment of the discretionary spending limits for 1993.

The International Situation Has Changed

First, the world has changed in ways that none of us could foresee last October, when the BEA was adopted. The probability of global nuclear war has **decreased**, and international cooperation shows new promise of helping to avert or solve regional conflicts. The defeat of Iraq by a **U.S.-led** coalition, the failed coup in the Soviet Union, and President Bush's moves to reduce U.S. nuclear weapons are only three of the unexpected events of the past 12 months. But not all recent developments have reduced the potential for conflict. As central governments have weakened, nationalist and ethnic movements have reemerged and pose their own threats to peace. Moreover, the high unemployment, shortages, and hyperinflation that are accompanying the transformation from command to market economies are conducive to the return of authoritarian regimes.

By themselves, the reductions in nuclear weapons recently announced by Presidents Bush and Gorbachev will have little effect on defense spending, as compared with the Administration's fiscal year 1992 budget. But if these cuts in nuclear weaponry are followed by reductions in forces and **programs--for example**, in the planned B-2 bomber fleet, aircraft carrier battle groups, army divisions, or the Strategic Defense **Initiative--the** budgetary savings could be substantial.

The Caps Are Starting to Pinch

It is also beginning to hit home that the discretionary spending limits will prove more restrictive in the future than they have so far. The domestic discretionary caps for fiscal years 1992 and 1993 were designed to allow spending to continue at roughly the 1991 levels, adjusted for inflation. But even these limits have been difficult to satisfy for 1992, and for several reasons the situation will be even tougher in 1993. First, in attempting to meet the 1992 outlay limits, while providing every dollar of the available budget authority, the 1992 appropriation bills have employed devices such as obligation delays. Although delaying obligations helps to solve this year's problem, it will make the 1993 caps unexpectedly and uncomfortably tight. Second, the domestic caps must be adjusted downward next January by more than \$2 billion in budget authority and more than \$1 billion in outlays to reflect lower inflation for 1991 than anticipated in the BEA. All in all, depending on the mix of appropriations in 1992 and the degree of optimism in the Administration's 1993 budget estimates, domestic discretionary outlays might have to be cut between \$4 billion and \$8 billion below the baseline in 1993 to stay within the cap.

Defense outlays, too, could become a problem in 1993. More Desert Storm-related outlays than originally thought will probably spill into 1993. Although appropriations for Desert Storm were an emergency and thus entailed a revision to the caps, this revision is made only once. The Office of Management and Budget (OMB) can not update estimates of emergency legislation for subsequent changes

in spending rates. Thus, unless OMB turns a blind eye to this higher spending when **gauging** compliance with the 1993 caps, other defense outlays will be cramped. And, as with domestic spending, the inflation **adjustment** will lower the defense caps by about \$3 billion in budget authority and \$2 billion in outlays.

Beyond 1993, the caps get much tighter. In 1994, defense, international, and domestic discretionary spending must compete for their share of a discretionary total that is slightly smaller than 1993's dollar level. The Congressional Budget Office's (CBO's) August update report describes two scenarios that illustrate the size of the reductions that might be required to meet the caps in 1994 and 1995 (see Table 1). Under both of these alternatives, or any other option, the next President and the next Congress will face unpalatable choices in meeting the discretionary spending limits for the 1994 budget.

The first hypothetical scenario assumes acceptance of the President's fiscal year 1992 defense request, which incorporates a real reduction of 3 percent a year in military spending. The remaining cuts needed to meet the caps must come from the nondefense side of the budget, which in this case would have to undergo real reductions of about 7 percent in 1994 and another 3 percent in 1995.

The second scenario maintains nondefense programs at their real 1993 level and takes all of the needed cuts from the defense budget. In this path, defense would be cut by 8 percent in 1994 and another 6 percent in 1995, more than twice

TABLE 1. MEETING THE DISCRETIONARY BUDGET AUTHORITY
CAPS IN FISCAL YEARS 1994 AND 1995
(In billions of dollars)

Spending Category	1993 Cap	Scenario 1: Assume President's Defense Request		Scenario 2: Assume Nondefense at Baseline	
		1994	1995	1994	1995
Defense					
Assumed budget authority	291.5	295.5	298.5	279.0	274.1
Baseline		303.9	316.9	303.9	316.9
Cuts required					
In dollars		-8.4	-18.4	-24.9	-42.8
As a percentage		-2.7	-5.8	-8.2	-13.5
International					
Assumed budget authority	22.9	22.2	22.3	23.8	24.7
Baseline		23.8	24.7	23.8	24.7
Cuts required					
In dollars		-1.6	-2.4	0	0
As a percentage		-6.9	-9.7	0	0
Domestic					
Assumed budget authority	207.4	200.4	204.3	215.3	226.2
Baseline		215.3	226.2	215.3	226.2
Cuts required					
In dollars		-14.9	-21.9	0	0
As a percentage		-6.9	-9.7	0	0
Total Discretionary					
Assumed budget authority	521.7	518.1	525.0	518.1	525.0
Baseline		543.0	567.8	543.0	567.8
Cuts required					
In dollars		-24.9	-42.8	-24.9	-42.8
As a percentage		-4.6	-7.5	-4.6	-7.5

SOURCE: **Congressional Budget Office.**

NOTES: The caps **shown** are those the budget **resolution assumes**.

The **baseline** projections for 1994 and 1995 are based on 1993 appropriations that are **assumed** to be equal to the 1993 **caps**.

The CBO **reestimate** of the **President's defense** request **assumes** no change in pay dates or in accounting for the accrued **cost** of military retirement.

as deep a cut as the President has proposed. To accomplish the reductions in defense outlays required by this scenario without severe cuts in military personnel or investment, defense spending would have to be cut below the **President's** request starting in 1993, and some of the budget authority available under the caps in 1993, 1994, and 1995 would have to remain unused. It is worth noting that even in this scenario, nondefense discretionary spending would not be treated generously by historical standards.

Adjusting the Limits Is a Partial Solution

Some observers have tried to harmonize these two themes by suggesting that reallocating discretionary spending from defense to international or domestic in 1993 would help meet the total discretionary caps, especially in 1994. But this is a vain hope. Taken together, the stream of outlays flowing from an appropriation is remarkably similar for the defense, international, and domestic categories. Therefore, merely moving money from one category to another will not make the discretionary outlay totals any easier to achieve, either in 1993 or later.

A variation on the theme is the suggestion that, in order to help meet the caps in 1994 and 1995, the Congress should not embark on major defense or nondefense investment projects that entail large spending commitments in the future. But this premise is only a partial truth. Although it makes no sense to start

a project if funds will be too scarce to carry it through to completion, redirecting the same money to a **noninvestment** project also fails to slow the momentum of spending. To make a real contribution to meeting future outlay targets, money not appropriated for the space station, superconducting super collider, or other such long-term project would have to remain unspent.

Experience with the previous versions of the Balanced Budget Act suggests that, when targets become too tough to meet, the targets get raised. But such a retreat is not inevitable. The 1994 outlay cap can be met if policymakers plan ahead. It will be extremely difficult to satisfy the 1994 cap if the full amount of available discretionary budget authority is appropriated in fiscal year 1993, no matter how it is divided. Of course, optimistic estimating assumptions and creative accounting can **help--just** as they helped the Administration and the Congress pretend in 1989 that the 1990 deficit would come close to the \$100 billion target. (The actual deficit, at \$220 billion, was more than twice that.) But a more honest way to meet the 1994 outlay target would be to reduce the total amount of discretionary budget authority appropriated in 1993 and 1994, either through an explicit reduction in the caps or through voluntary legislative restraint.

The Congress may still wish to rearrange the spending caps in 1993 to reflect new spending priorities, even though this change will not help meet the outlay targets. There are at least four ways to shift discretionary spending from one category to another:

- o Leave the three 1993 caps as they are, but fund selected **items--for** example, aid to the Soviet Union or part of the National Aeronautics and Space **Administration--from** the defense budget.
- o Retain three separate caps, but shift budget authority and outlays from the defense to the international or the domestic category.
- o Combine defense and international discretionary spending into a single category.
- o Consolidate all three caps into one.

The last three options, which require amending the law, have the virtue of directness and avoid bending or breaking the traditional functional classifications used in the budget. But sometimes indirection, as in the first option, may be the preferred course. Several features of the BEA are designed to keep the new law intact until early 1993, after the 1992 elections, and changing the law is not easy. Both the Administration and the Congress may conclude that it is better to fit their spending plans within the existing caps for another year than to reopen contentious budgetary issues earlier than necessary.

WHY IS MORE DEFICIT REDUCTION NEEDED? _____

Come 1993, however, the budget will certainly return to the top of the political agenda. According to the Congressional Budget Office's latest estimates, the deficit, excluding spending for deposit insurance, will remain around \$200 billion for the foreseeable future, and may even start to move higher toward the end of the 1990s. Total borrowing, including that required to resolve insolvent banks and savings and loans, approached \$300 billion in fiscal year 1991 and is almost certain to exceed \$300 billion in 1992 (see Table 2). At this rate, the public debt will reach its statutory limit by early 1993; the need for legislation to raise the limit may once again force a revision of the budget process, as it did in 1985, 1987, and 1990. In January 1993, the newly elected President will also decide whether to adjust the deficit targets in the BEA for updated estimating assumptions. If the outlook for the deficit worsens, a decision not to adjust the targets would be tantamount to convening a new budget summit because it would once again raise the threat of a large sequestration.

Budget Deficits Impair Economic Growth

Although the Budget Enforcement Act does not require any additional deficit reduction until at least fiscal year 1994, the budget deficit remains a serious economic and social problem. Large budget deficits reduce national saving by

TABLE 2. CBO BASELINE BUDGET PROJECTIONS (By fiscal year)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
In Billions of Dollars											
Revenues	1,058	1,141	1,223	1,299	1,377	1,449	1,532	1,618	1,707	1,802	1,902
On-budget	764	830	891	946	1,000	1,049	1,107	1,167	1,230	1,296	1,366
Off-budget	294	312	333	354	376	400	425	450	477	506	537
Outlays											
Defense discretionary	322	314	295	a	a	a	a	a	a	a	a
International discretionary	20	20	21	a	a	a	a	a	a	a	a
Domestic discretionary	197	215	225	a	a	a	a	a	a	a	a
Subtotal	539	549	541	539	544	563	585	608	633	658	684
Mandatory spending	638	694	740	787	839	895	962	1,032	1,111	1,196	1,286
Deposit insurance	77	115	58	32	-32	-44	-31	-23	-16	-13	-10
Net interest	196	208	229	246	257	266	278	291	306	323	342
Offsetting receipts	-113	-63	-66	-70	-73	-75	-80	-84	-89	-93	-97
Total	1,337	1,504	1,501	1,534	1,534	1,605	1,714	1,825	1,945	2,071	2,205
On-budget	1,096	1,255	1,239	1,263	1,252	1,311	1,409	1,508	1,616	1,731	1,853
Off-budget	241	249	262	270	281	294	305	317	329	340	352
Deficit(-) or Surplus	-279	-362	-278	-234	-157	-156	-182	-208	-238	-269	-303
On-budget	-331	-425	-348	-318	-252	-262	-301	-341	-387	-435	-487
Off-budget	52	63	70	83	95	106	120	133	149	166	185
Deficit Excluding Deposit Insurance and Desert Storm Contributions	-250	-248	-220	-202	-189	-200	-213	-230	-254	-282	-313
As a Percentage of GNP											
Revenues	18.9	19.2	19.4	19.4	19.4	19.2	19.2	19.1	19.0	19.0	18.9
On-budget	13.7	14.0	14.1	14.1	14.1	13.9	13.9	13.8	13.7	13.6	13.6
Off-budget	5.3	5.2	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3
Outlays											
Defense discretionary	5.8	5.3	4.7	a	a	a	a	a	a	a	a
International discretionary	0.3	0.3	0.3	a	a	a	a	a	a	a	a
Domestic discretionary	3.5	3.6	3.6	a	a	a	a	a	a	a	a
Subtotal	9.6	9.2	8.6	8.0	7.7	7.5	7.3	7.2	7.1	6.9	6.8
Mandatory spending	11.4	11.7	11.7	11.7	11.8	11.9	12.0	12.2	12.4	12.6	12.8
Deposit insurance	1.4	1.9	0.9	0.5	-0.5	-0.6	-0.4	-0.3	-0.2	-0.1	-0.1
Net interest	3.5	3.5	3.6	3.7	3.6	3.5	3.5	3.4	3.4	3.4	3.4
Offsetting receipts	-2.0	-1.1	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0
Total	23.9	25.3	23.8	22.9	21.6	21.3	21.4	21.6	21.7	21.8	21.9
On-budget	19.6	21.1	19.6	18.9	17.6	17.4	17.6	17.8	18.0	18.2	18.4
Off-budget	4.3	4.2	4.2	4.0	4.0	3.9	3.8	3.7	3.7	3.6	3.5
Deficit(-) or Surplus	-5.0	-6.1	-4.4	-3.5	-2.2	-2.1	-2.3	-2.5	-2.6	-2.8	-3.0
On-budget	-5.9	-7.2	-5.5	-4.7	-3.5	-3.5	-3.8	-4.0	-4.3	-4.6	-4.8
Off-budget	0.9	1.1	1.1	1.2	1.3	1.4	1.5	1.6	1.7	1.7	1.8
Deficit Excluding Deposit Insurance and Desert Storm Contributions	-4.5	-4.2	-3.5	-3.0	-2.7	-2.6	-2.7	-2.7	-2.8	-3.0	-3.1

SOURCE: Congressional Budget Office.

a. A single cap applies to the three categories of discretionary spending--defense, international, and domestic--in 1994 and 1995. The assumed caps for fiscal years 1996 through 2001 are CBO extrapolations.

absorbing part of the funds set aside by businesses and households, funds that would otherwise go largely into productive investment in the private sector of the economy. Expanded productive capital is one of the best-understood sources of economic growth. Reducing the deficit, as long as it does not impair federal spending for public investment, will expand saving and capital formation, reduce borrowing from abroad, and increase the rate of growth of U.S. standards of living.

In previous testimony and reports, the Congressional **Budget** Office has frequently shown how reducing the deficit today will lead to higher living standards in the future. But such calculations were distant and abstract, and therefore possibly unconvincing. A recent study from the Federal Reserve Bank of New York may be more compelling because it shows how the economy is already paying a heavy price for the low saving of the 1980s.¹

Both private and public saving have shrunk as a percentage of gross national product (GNP) in the last decade. The sum of real private and public saving as a share of GNP averaged 7.3 percent from 1952 through 1979, but only 2.9 percent in 1980 through 1990. The federal government bears a large part of the responsibility for the drop in saving. On a national income and product accounts basis, the budget deficit, which averaged 0.9 percent of GNP from 1952 through 1979, swelled to 3.7 percent of GNP in the 1980-1990 period.

1. Ethan S. Harris and Charles Steindel, "The Decline in U.S. Saving and Its Implications for Economic Growth," *Federal Reserve Bank of New York Quarterly Review*, vol. 15 (Winter 1991), pp. 1-19.

The analysts at the Federal Reserve Bank of New York find that the drop in saving during the 1980s has already reduced the productive capacity of the U.S. economy by about 5 percent. If the current low level of saving continues, the researchers estimate that the loss in potential **GNP** will grow to 10 percent by the end of the decade. In other words, the slow increase in productivity and the sluggish rise of incomes that arouse so much current concern stem in no small measure from excessive private and public consumption during the 1980s.

Budget Deficits Increase Interest Costs

Budget deficits also create a vicious cycle of more federal borrowing and higher debt service costs, which in turn make it still more difficult to reduce the deficit. In 1981, for example, the public held less than \$800 billion of federal debt, and net interest costs amounted to 2.3 percent of GNP. Today, despite much lower interest rates, the debt approaches \$2.7 trillion, and interest amounts to 3.5 percent of GNP.

What is particularly striking is the way in which the rise in interest costs has undone the hard-fought reductions in discretionary spending. In 1981, defense and nondefense discretionary spending absorbed 10.8 percent of GNP. In 1991, after a decade of restraint, discretionary spending has shrunk to a postwar low of 9.6 percent of GNP. But the decline in discretionary **spending--1.2 percent of GNP--is** precisely equal to the increase in interest costs. Together, discretionary spending

and net interest spending are as large as they were 10 years ago, but a larger portion is consumed by interest, and a smaller portion is being devoted to programs that provide services and satisfaction to the public.

HOW SHOULD THE BUDGET PROCESS BE CHANGED?_____

Laws explicitly designed to control the budget deficit have been on the books for six years. These extraordinary procedures have inevitably shifted power from the legislature to the **executive** branch, limited the roles of the authorizing committees of the Congress, and subjected the budget process to increasingly arcane rules that are interpreted and understood by only a small priesthood of unelected technicians. Nonetheless, the projected deficits now are higher than they were after **Gramm-Rudman-Hollings** was adopted in 1985. Based on this record, one is tempted to conclude that sequestration and other related elements of the budget process have been failures, or, at the very least, are not worth the costs they have imposed.

I continue to believe, however, that such a conclusion is too pessimistic. Although the deficit is still far too high, it would be even worse without the Budget Enforcement Act and its predecessors. Last year, the threat of a huge sequestration was one of the factors that kept Administration and Congressional negotiators at the bargaining table from May through September and ultimately resulted in a record of nearly \$500 billion in deficit reduction measures. This year, the discretionary

spending limits and pay-as-you-go regime are making sure that new legislation does not dissipate these hard-fought savings. And in 1993, the specter of sequestration may again scare policymakers into taking further action to reduce the deficit.

I still hope that, at some point, the deficit will be brought down to reasonable levels, the Balanced Budget Act processes can be dispensed with, and budgeting will cease to be an all-consuming activity. But that day is not yet in sight. In the meantime, how can the budget process be strengthened?

First, some version of the discretionary caps and pay-as-you-go requirement should be extended past 1995. The multiyear horizon of the BEA was a major step forward, because it thwarted the timing shifts that had been used to achieve the semblance of compliance with the old fixed deficit targets. As 1996 nears, however, the temptation to delay spending to a year not covered by the BEA will increase. Extending the enforcement procedures will deter this sort of legislative legerdemain.

Second, ways must be devised to slow the growth of mandatory spending, especially for health care services. Currently, the Budget Enforcement Act requires that legislated expansions in mandatory spending programs must be financed by tax increases or compensating spending cuts. But this goal may not be ambitious enough. According to a long-range extrapolation, which CBO prepared at the request of this Committee, non-Social Security entitlement spending could balloon from 6.7 percent of **GNP** today to 8.1 percent of **GNP** by 2001 under current

policies. All of this growth is concentrated in Medicare and Medicaid, which are propelled by the rapid rise in the cost and use of medical care. Yet at the same time the costs of health care are gobbling up an increasing share of national output, 16 percent of the U.S. population under 65 has no health insurance. Thus, solving the deficit problem may not be possible without dealing with the problems of health care costs and access as well.

Third, consideration should be given to establishing targets for deficit reduction, rather than targets for the deficit. As the BEA now stands, sequestration to achieve the maximum deficit amounts may loom again in fiscal years 1994 and 1995 if the President decides not to adjust the deficit targets for economic and technical factors. But the amount of deficit reduction the BEA requires will be a happenstance, reflecting the vagaries of the economy and the accuracy of the budget estimators. The required deficit reduction might be too small to give much of a boost to national **saving**, or it might be absurdly large, as it eventually became under **Gramm-Rudman-Hollings I and II**. As an alternative, the law could require a specified amount of deficit **reduction--say, \$35 billion to \$50 billion a year--for a number of years, or until a target deficit is reached**. This objective would have to be backed up by a more convincing threat than the current sequestration, which exempts 95 percent of mandatory programs in whole or in part. As one possibility, failure to achieve the required deficit reduction could trigger an automatic surcharge on personal and corporate income tax payments.

CONCLUSION

During the 1980s, discretionary spending was held on a short leash, and the possibilities of further cutbacks in this area are correspondingly limited. In fact, some analysts are now worried that the efforts to limit discretionary spending have gone too far, and that investments in infrastructure, education, and other forms of public capital are being shortchanged. Spending on interest, another major category of spending, is completely beyond any direct governmental control.

That leaves only two ways of making a significant dent in the **deficit--cutting** entitlement programs and raising taxes and fees. No change in the budget process will make either step easy, and no change in the process will bring about a lower deficit if the will to make the needed changes is lacking.