Statement of
Robert D. Reischauer
Director
Congressional Budget Office

before the
Legislation and National Security Subcommittee
Committee on Government Operations
U.S. House of Representatives

April 4, 1990

NOTICE

This statement is not available for public release until it is delivered at 10:00 a.m. (EDT), on Wednesday, April 4, 1990.

Mr. Chairman, I am pleased to appear before the Committee this morning to discuss the efficacy of the Balanced Budget Act process and the need for further procedural reforms. I will also comment on legislation recently introduced by Chairman Panetta (H.R. 3929) and by Congressman Russo (H.R. 4164) that would make major changes in the current budget process.

My testimony today will make four major points:

- It is important to continue efforts to reduce the federal deficit in order to increase national saving and investment;

- Setting longer-term targets for budget surpluses should wait until a balanced budget is closer to realization;

- The Balanced Budget Act has a number of problems, and some procedural changes would be useful; but

- Achieving real and long-lasting deficit reductions in the next few years will do the most to restore the integrity of the budget process.

THE NEED FOR DEFICIT REDUCTION

The primary reason for continuing efforts to reduce the federal deficit is that national saving today is much too low by both historical and international standards. This low saving rate translates into slow growth in living standards by restricting the pool of capital available for productive private investment. While a net inflow of foreign capital can substitute for domestic saving and maintain productivity, it also means that an increasing share of our output must go to pay interest and dividends to foreign creditors, which will depress the growth of our living standards.

The low rates of American saving and investment are particularly disturbing because of the demographic changes that are under way. In the United States today, there are 3.3 members of the labor force for every Social Security retiree. This relationship will remain roughly constant for the next 20 years but then will decline sharply between 2010 and 2030 to about two workers for each retiree. The best way to help the nation adjust to this demographic change is to encourage economic growth now so that the nation will be better able to support an aging population.

The most direct way for the government to encourage economic growth in the long run is to take actions that add to national saving, and the most effective way to do that is to reduce the deficit. Reducing the federal deficit will increase national saving during the 20 or so years that remain before the baby-boom generation begins to retire. This increased saving will permit greater investment at home and abroad, promote higher economic growth, and raise the amount of income that will be available for sharing by future workers and retirees. These improvements should make the inevitable allocation of more resources to retirees less of a strain on the working population of that time.

The President proposes to spur saving and investment by excluding up to 30 percent of capital gains from taxation, establishing Family Savings Accounts, and allowing penalty-free early withdrawals from Individual Retirement Accounts for first-time homebuyers. These proposed incentives would increase the return to saving, but they cannot be counted on to raise the national saving rate significantly. Once again, the surest way to increase national saving is to reduce the federal deficit.

Reducing the federal deficit could have several additional benefits. It could, for example, reduce interest rates and thus improve prospects for many interest-sensitive sectors in the United States as well as benefit debt-burdened countries abroad. It could reduce the trade deficit, and with it the inflows of foreign capital to the United States. Finally, it could also ease the burden of the Federal Reserve system in managing the economy and reduce the likelihood of sharp swings in financial markets.

Both the Russo bill (H.R. 4164) and the Panetta bill (H.R. 3929) address this need for further deficit reduction. They would strengthen current budgetary procedures for achieving deficit reduction. They would also extend the time horizon for deficit reduction efforts and try to achieve budget surpluses in the near future.

SETTING DEFICIT TARGETS

Recent discussions of budgetary policy, however, have become mired in confusion over what the real federal deficit is. For the most part, this confusion has arisen over accounting for the surpluses of the Social Security trust funds. Many proposals, including the Russo and Panetta bills, would take Social Security out of the budget calculations, and the President's budget also contains a proposal to change the accounting procedures for the Social Security surpluses. For some time, however, CBO has argued that the proper deficit to target is one that measures the extent to which the federal government draws on private saving to finance government consumption.

The chief importance of the federal deficit as a measure is that it accounts for the government's use of private saving. When the deficit increases (other than for additional spending on physical or human investments), the government is diverting more private saving to public consumption. When the deficit is cut, the government is using less saving. The annual balance in the Social Security programs affects national saving in exactly the same way as the balance in any other government accounts and, therefore, should be included in any deficit calculations.

This is not to say that the appropriate deficit target is necessarily a balanced total budget, including Social Security. Some analysts believe that limited deficits are acceptable because much federal spending yeilds long-term benefits. To others, a balanced budget is good enough. For example, Alice Rivlin and Henry Aaron have suggested recently that surpluses of about 1 percent of gross national product (GNP) would be desirable in the late 1990s. Still others, including the President and Chairman Panetta, propose that we go further and aim for overall budget surpluses after 1993 that are equal to those now scheduled for Social Security, which will average 2 percent of GNP in the late 1990s. The Russo bill (H.R. 4164) also would require a large budget surplus to be achieved after 1993. Deficit reduction under the Russo bill would no longer be required when the deficit, not including any tax-supported trust funds, is less than one-half of 1 percent of GNP.

With the current targets proving hard enough to reach, pinpointing ambitious targets for the late 1990s seems premature. The deficit currently hovers near 3 percent of GNP. To arrive at a surplus of 1 percent to 2 percent of GNP, involves passing through zero, or budget balance, first. Even if recent progress can be accelerated, achieving a balanced budget is still some years off. Setting realistic targets aiming to balance the budget over the next few years, and then attaining them, has to be the number one priority for deficit reduction, to my way of thinking.

Once the balanced budget bird is in the hand rather than flitting around in the bush, so to speak, Congressional attention should then focus on longer-term budgetary goals. The case for surpluses in the total budget rests implicitly on two assumptions. One is that private investment should be the major focus of efforts to spur economic growth. The second is that private saving will continue to prove insufficient to fund such investment; thus, the government should supplement it with public saving or surpluses.

Support for this case is, however, far from universal. First, a public investment strategy for spurring economic growth could be pursued. I am referring here to a set of policies that would stress expanding investment in human capital, infrastructure, and research and development. Pursuing such a strategy might imply long-run federal deficit targets quite different from the big surpluses the

Committee is now considering. Second, the baby-boom generation is entering its years of high saving. So far, little evidence indicates that the overall saving rate is picking up. But it is too early to tell and, with each passing year, the evidence should become clearer.

My task today is certainly not to recommend a public investment approach for spurring growth. My point is, though, that this approach deserves a serious hearing. A fair hearing will be possible only when the current huge deficit is much lower. All of this implies that it is premature to lock the government into a course of ever-growing surpluses before a specific approach to growth has been decided. I see absolutely no loss to setting and achieving near-term targets on balancing the budget, but you should reserve the choice of how much more the government should do to spur growth and how it should go about it.

HOW WELL HAS THE BALANCED BUDGET ACT WORKED?

By now, the defects of the Balanced Budget Act (Gramm-Rudman-Hollings) are well known, but let me briefly run through the litany of complaints about the act. To begin, it has encouraged the use of overly optimistic economic and technical estimating assumptions to avoid the need for making greater efforts to reduce the deficit. It has also focused the budget process on a single year and sometimes lost sight of the long-term objective, which is a slow but steady reduction in the federal deficit. Moreover, it has spawned accounting changes and other gimmicks that give the illusion of deficit reduction without the substance. Finally, it has fostered cynicism about the honesty of the budget process and undermined the public image of politicians and political institutions.

These criticisms are valid and important, but they beg the question of whether Gramm-Rudman-Hollings has worked to reduce the deficit. The budget deficit in 1986 was $221 billion, even with a sequestration of $11.7 billion. Since then, however, the deficit has been reduced to between $150 billion and $155 billion, and as a percentage of GNP the decline has been sharper--from 5.3 percent in 1986 to 2.9 percent in 1989.

But has the Balanced Budget Act produced these outcomes? Several factors can be cited to the contrary. One is that, as is widely discussed, growing Social Security surpluses account for a substantial share of the progress being made. These surpluses were set into law in 1983, before Gramm-Rudman-Hollings. Similarly, the change in public and Congressional sentiment toward restraint in the defense budget--another major contributor to improving budget outcomes--antedates the Balanced Budget Act.

On the other side, however, some people have cited the Balanced Budget Act's usefulness in converting a mere sentiment toward defense restraint to concrete action. Moreover, nondefense discretionary programs have grown no faster than GNP since enactment of the Balanced Budget Act, despite Congressional sentiment to increase them. On balance, I believe that the major effect of Gramm-Rudman-Hollings has been to restrain new spending initiatives.

There is no profit, however, in exhuming the past accomplishments or lack thereof of Gramm-Rudman-Hollings. The important question is whether the key attributes of the act are likely to reduce the deficit in the future. These attributes are the setting into law of rigid numerical deficit targets and establishing the sequestration procedure as a threat to impel action. Even if dollar targets are set five years into the future, one could virtually guarantee that they will need emendation and that they will encourage use of overly optimistic assumptions. It is equally agreed that a threat of sequestration, which would set the defense share at 50 percent, is far less daunting today in an era when the Administration is proposing sizable defense reductions than it was when the executive branch was strongly advocating substantial real growth in the defense budget. Accordingly, some changes in Gramm-Rudman-Hollings seem warranted if it is to work as well--however well that may be--in the future as in the past.

The Russo and Panetta bills differ in important ways in the specific details of how they would respond to the new challenge. The Russo bill sets numerical targets for deficit cuts, not levels, and it modifies the sequestration formula to conform to one version of the new reality. Chairman Panetta's bill sets annual targets for deficit cuts in a way that is less rigid than Gramm-Rudman-Hollings--a miscalculation in one year will not foredoom the realism of the targets ever after as Gramm-Rudman-Hollings does--and it kills sequestration altogether, substituting strengthened control through points of order in its stead.

Either approach strikes me as potentially workable, although internal Congressional procedures may not be as credible as sequestration. I think the efficacy of either one will depend much more on raising the level of cooperation and compromise between the Congress and the White House. I wish I could give you some magic formula for attaining that goal, but obviously none exists. What I can say is that I am extremely skeptical that any new legislation on the budget process is the key to the changes that are needed.

SOME POSSIBLE PROCEDURAL CHANGES

Unfortunately, fiscal year 1990 will prove to be disappointing in terms of achieving significant deficit reduction. The deficit target for 1990 is

$100 billion, but CBO's current estimate of where the deficit actually will come out is $159 billion. Roughly a third of this difference can be attributed to the failure to carry out fully the 1989 budget agreement and to the enactment of legislation that was not included in the agreement. I refer here principally to the repeal of the catastrophic health insurance program, the enactment of the savings and loan rescue legislation, and to the provision of funds for drought relief and disaster assistance.

The remaining portion of the higher 1990 deficit results from various economic and technical reestimates, almost half of which were projected by CBO, but not accepted by the Congress, when the agreement was reached in April last year. Later reestimates have focused largely on the costs of resolving the savings and loan problem, most notably the provision of working capital to the Resolution Trust Corporation (RTC) by loans from the Treasury's Federal Financing Bank.

Fiscal year 1991 will also prove to be disappointing. The Congressional Budget Office (CBO) estimates that the 1991 budget deficit under the President's policy **proposals--which** purport to meet the deficit target of $64 billion-would be $131 billion, almost $70 billion higher than the Administration's estimate. This difference in estimates arises largely because the President's budget makes no allowance for the sizable needs of the RTC for working capital and because it uses more optimistic economic assumptions.

The budgetary landscape for the next several years is clouded by the costs of the savings and loan crisis, which can wreak havoc with an orderly plan for achieving the Balanced Budget Act deficit targets. For some time, CBO has argued that RTC spending should be included in the budget totals but largely excluded from the Gramm-Rudman-Hollings calculations. The rationale for excluding it is that such spending does not affect national saving or consumption in the way most federal spending does and that it would also be consistent with the treatment of asset sales under the act.

The Panetta (H.R. 3929) bill does not specifically exclude the Resolution Trust Corporation from future deficit calculations, although the transactions of the RTC could be excluded effectively under its credit reform provisions. The Russo bill (H.R. 4164) contains a provision to prevent the budget deficit from being reduced by RTC asset sales during the remaining years of the Balanced Budget Act, but no provision for preventing the budget deficit from being increased by RTC spending. Under CBO's latest budget estimates, the activities of the RTC are estimated to increase the 1991 deficit by nearly $30 billion, or almost the same amount as would be cut from the budget by the President's budget proposals.

The focus on reaching deficit reduction targets in both the Panetta and Russo bills, rather than specific deficit levels, could be an improvement over the current Gramm-Rudman-Hollings procedures. It should lessen the incentive to adopt optimistic economic assumptions for the President's budget or Congressional budget resolutions. The more optimistic assumptions used for the President's budget, for example, produce a projected deficit that is $26 billion lower than that projected by CBO.

A particularly damaging defect of the Balanced Budget Act is its budgetary myopia--its exclusive focus on next year's deficit with little heed to long-run consequences. Although looking too far into the future poses its own problems, total preoccupation with the here-and-now has two major flaws. First, it diverts attention from the real reason for fiscal responsibility--namely, to raise America's saving rate over the long run--and makes deficit reduction an end in itself. Good public policy can never be made when symbols subvert substance in this way. Second, myopia has encouraged budgetary chicanery, such as shifted pay days, accelerated tax collection, and other accounting gimmicks.

Both the Panetta and Russo bills would extend the focus of deficit reduction beyond the budget year. They would eliminate the most egregious of budgetary gimmicks, that of shifting outlays or revenues from one year to another to achieve favorable deficit results in the budget year. The Panetta bill also revises and clarifies a number of other accounting rules and definitions that should help make the budget process more rational and comprehensible to the participants.

These proposed changes are appealing and should help to restore the integrity of the budget process.

Another appealing feature of the Panetta bill is its proposal to change the budgetary treatment of credit programs to reflect more accurately their real cost to the government, which would eliminate another source of budgetary chicanery. CBO has recently submitted a report to the Congress on the need for credit reform, which both the General Accounting Office and the Administration also support. While we would have some concern about some of the specific credit reform provisions in the Panetta bill--for example, treating deposit insurance as a credit program rather than excluding noninterest spending by the RTC--on the whole it would be a definite improvement over current budgetary practice.

Both bills also contain "pay-as-you-go" features. The Panetta bill employs a pay-as-you-go concept for setting annual deficit reduction targets, and the Russo bill applies a pay-as-you-go or a deficit-neutral concept to new budgetary initiatives. The latter approach has been used before--for example, with the Tax Reform Act of 1986 and with amendments to reconciliation bills.

While these proposals have some appeal, the experience of the last few years makes it clear that every attempt at reforming the budget process has unintended consequences. The importance of baseline definitions to the pay-as-you-go concept, for example, could lead to some new budgetary games over calculating the baselines to give the appearance but not the substance of deficit reduction or deficit neutrality. Enforcing the pay-as-you-go concept could also lead to adopting even larger and more complex budget bills, which might result in bigger confrontations between the Congress and the President over budgetary policy. At the same time, however, these confrontations might also promote more negotiation and settlement of issues, and in that sense the pay-as-you-go concept could produce some useful results in the long run.

CONCLUSION

In the end, adopting real and long-lasting deficit reductions policies in the next few years will do more to restore integrity to the budget process than the proposals in either bill. Some changes in the budget process might make a contribution to reducing the deficit or to restoring credibility to the process. But large budget deficits and budgetary chicanery are not primarily the result of defects in the budget process. Rather, the process does not function well because profound political differences exist over how to reduce the deficit. Until there is a meeting of the minds on these policy issues, the budget deficit will remain undesirably high and complaints will persist about the inequities and perfidies of the budget process.