CBO TESTIMONY

Statement of
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before the
Legislation and National Security Subcommittee
Committee on Government Operations
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NOTICE

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Mr. Chairman and Members of the Subcommittee, thank you for inviting me to participate in your review of the limits on discretionary spending for fiscal year 1993. This morning my testimony will cover three topics:

- o The current outlook for the deficit and the reasons that additional deficit reduction is needed,

- o The factors causing a reassessment of the discretionary spending limits for 1993, and

- o The pros and cons of the Chairman's proposal to eliminate the barriers between the three categories of discretionary spending in 1993.

In my view, the discretionary spending limits 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 must take further steps to reduce the deficit. Combining the three separate discretionary spending limits for 1993 into a single overall cap will not cut the deficit. But it could spur economic growth in another way--by helping redirect federal spending away from defense and toward investment in infrastructure, education, research and development, and other forms of public capital.

WHY IS MORE DEFICIT REDUCTION NEEDED?

According to the Congressional Budget Office's (CBO's) latest estimates, the deficit, excluding spending for deposit insurance, will remain around $200 billion for the foreseeable future, and may even start to rise 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 1). At this rate, the public debt will reach its statutory limit by early 1993. At that time, 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.

Budget Deficits Impair Economic Growth

Although the Budget Enforcement Act (BEA) 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 absorbing part of the funds businesses and households set aside-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

TABLE 1. 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.

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, CBO 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 is far 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 plummeted to 2.9 percent in 1980 through 1990. The federal government bears a large part of the responsibility for this drop in saving. On a national income and product accounts basis, the budget deficit, which averaged 0.9 percent of gross national product 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 even 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 how this 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 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.

SHOULD THE DISCRETIONARY CAPS BE ADJUSTED?

For 1991 through 1993, the Budget Enforcement Act 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 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. Consider just four of the unexpected events of the last 12 months: the defeat of Iraq by a U.S.-led coalition, the failed coup in the Soviet Union, President Bush's moves to reduce U.S. nuclear weapons, and the Middle East peace conference.

Unfortunately, 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 Presidents Bush and Gorbachev recently announced will have only a modest effect on defense spending, when compared with the Administration's fiscal year 1992 budget. But the budgetary savings could be substantial if these cuts in nuclear weaponry are followed by reductions in forces and programs.

A recent CBO study, *The START Treaty and Beyond*, examines the effects of a wide range of options for reducing nuclear forces. For example, the United States could save from $9 billion to $16 billion a year over the next 15 years, compared with current plans, if it reduced its total strategic warheads to between 3,000 and 6,000 and curtailed its plans to deploy defense against ballistic missiles. The initial savings, however, would be smaller--perhaps $4 billion to $10 billion in budget authority in 1993.

Adopting any of the more far-reaching options outlined in the CBO study would require fundamental changes in the prevailing view about how many nuclear warheads are necessary to deter war. Nevertheless, the modern arsenals in all of these options would preserve substantial retaliatory capacity. Moreover, the options would be consistent with a world that focused more on cooperation than confrontation and could provide incentives for other important types of arms control, perhaps including limits on nuclear proliferation.

Nor are changes in nuclear forces the only potential source of defense cuts. Nuclear forces account for only 15 percent of the defense budget. Much larger savings would occur if a decision were made to reduce conventional forces such as aircraft carriers, tactical fighter wings, and Army divisions.

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 stay within for 1992.

As for 1993, the situation will be even tougher for several reasons. 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 only postpones the pain--the 1993 caps will be 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 was anticipated in 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 pose a problem in 1993. More outlays for Operation Desert Storm than were originally estimated 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) cannot 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 adjustment for inflation 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. CBO's August report, *The Economic and Budget Outlook: An Update,* describes two scenarios that illustrate the size of the reductions that might be required to meet the caps in 1994 and 1995 (see Table 2). 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.

TABLE 2. MEETING THE DISCRETIONARY BUDGET AUTHORITY CAPS IN FISCAL YEARS 1994 AND 1995
(In billions of dollars)

		Scenario 1: Assume President's Defense Request		Scenario 2: Assume Nondefense at Baseline	
Spending Category	1993 Cap	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.

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 spending would be cut by 8 percent in 1994 and another 6 percent in 1995, more than twice as deep a cut as the President has proposed. To accomplish the reductions in defense outlays this scenario requires 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.

If the Congress wished to rearrange the discretionary spending caps to reflect new spending priorities, several options are available.

The Walls Would Come Tumbling Down

Chairman Conyers' bill replaces the three separate limits on defense, international, and domestic discretionary spending in 1993 with a single limit on total discretionary spending, as is already in place for 1994 and 1995. Two other provisions of the bill assure that this change neither increases or decreases the total amount of spending in 1993. The special budget authority and outlay allowances for 1993 are redefined so that they apply to total discretionary spending rather than its three components. Furthermore, OMB is directed to recalculate any previous adjustments to the 1993 limits using the same economic and technical assumptions as it originally employed.

An alternative approach would be to leave the 1993 caps as they are, but to fund certain marginal items from the defense budget. The conference agreement on the 1992 defense appropriation, for example, allows the Department of Defense to spend up to $1 billion on humanitarian aid to the

Soviet Union. Compared with this alternative, the Conyers bill is direct and avoids bending or breaking the traditional functional categories in the budget. But sometimes indirection is the preferred course. It may be better to fit spending plans for 1993 into the existing caps than to reopen contentious budgetary issues during an election year, when it may be difficult to restrict changes to those that would reduce the deficit. In any case, several features of the Budget Enforcement Act virtually guarantee that the new law will be reexamined shortly after the 1992 elections.

The 1993 Cap is Too High

Whenever the Budget Enforcement Act is reopened, the Congress should design any changes to help meet the existing discretionary outlay targets and, even better, to make some further contribution to deficit reduction. Experience with the Balanced Budget Act suggests that, when targets become too tough, the targets get raised. But such a retreat is not inevitable. If policymakers plan ahead, they can meet the 1994 outlay cap.

Satisfying the 1994 outlay cap will prove tough going 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 could provide an out. But a more honest way to meet the 1994 outlay target would be to reduce the total amount of discretionary budget authority appropriated in both 1993 and 1994, either by explicit reduction in the caps or by voluntary legislative restraint.

More Public Investment May Also Spur Growth

Although establishing a single discretionary spending cap for 1993 will not contribute to economic growth by reducing the deficit, it could improve future living standards by another route: namely, a reallocation of discretionary spending toward investment-type activities could add to productivity and growth. Of course, domestic discretionary spending could be redirected toward investment purposes without increasing the total. But it may be easier to increase domestic investment by reducing defense spending than by making offsetting reductions in other domestic programs.

As I noted earlier, investment is a principal source of economic growth. Many who hear this argument, however, mistakenly assume that it applies primarily, or even exclusively, to private investment. But public-sector capital plays an equally important role in expanding the economy's productive capacity.

In a report released last July, *How Federal Spending for Infrastructure and Other Public Investments Affects the Economy*, CBO looked at three broad classes of federal investment spending: physical infrastructure, including transportation and environmental facilities; human capital, including programs that increase the skills and knowledge that people bring to their jobs; and intangible capital, such as research and development. The study found that targeted spending in each of these three areas could be productive. But high returns can be expected only on carefully selected projects. Little evidence exists to support claims that across-the-board increases in certain categories of public capital spending would yield rates of return that are greater, on average, than the return on investment in the private sector.

CONCLUSION

The recent decline in East-West tensions has prompted many proposals to modify the discretionary spending limits for 1993. The prospect of redirecting resources from defense to domestic needs is indeed an appealing one. Moreover, increasing the proportion of discretionary spending devoted to public investments could make a modest contribution to increasing the economy's growth in the long run. But large budget deficits remain the most serious threat to the economy's future. Therefore, a substantial part of any peace dividend should be devoted to deficit reduction.