

Statement of
Rudolph G. Penner
Director
Congressional Budget Office

before the
Committee on Appropriations
United States Senate

NOTICE

This statement is not available for public release until it is delivered at 1:30 p.m. (EST), Wednesday, February 26, 1986.

Mr. Chairman, at the request of this Committee, the Congressional Budget Office (CBO) has prepared an analysis of the President's budgetary proposals for 1987. Copies of our report have been distributed to Members, and I am pleased to have the opportunity this afternoon to summarize its findings.

Our analysis of the President's budget is made in terms of changes from the CBO baseline projections for 1987-1991. These projections were presented in detail last week in the first volume of our annual report to the Budget Committees. ^{1/} We believe they provide a useful basis for isolating the impact of proposed policy changes in spending and tax provisions from economic and other factors that affect the federal budget. In order to prepare this analysis, we reestimate, or reprice, the President's budget using CBO's economic and technical estimating assumptions and methods. This produces a somewhat different set of budget numbers than those presented in the Administration's budget documents.

CBO BUDGET ESTIMATES

CBO estimates that the federal government deficit under Administration policies would decline from \$204.7 billion in 1986 to \$159.7 billion in 1987 and \$40.1 billion in 1991. The Administration's program would reduce total

1. See Congressional Budget Office, The Economic and Budget Outlook: Fiscal Years 1987-1991 (February 1986).

spending and the deficit substantially compared with CBO's baseline projections. Using CBO's economic assumptions and technical estimating methods, however, the resulting deficit exceeds the 1987 target in the Balanced Budget and Emergency Deficit Control Act of 1985 (Public Law 99-177) by \$15.7 billion (see Figure 1 and Table 1).

TABLE 1. THE BUDGET OUTLOOK UNDER ADMINISTRATION POLICIES (By fiscal year, in billions of dollars) a/

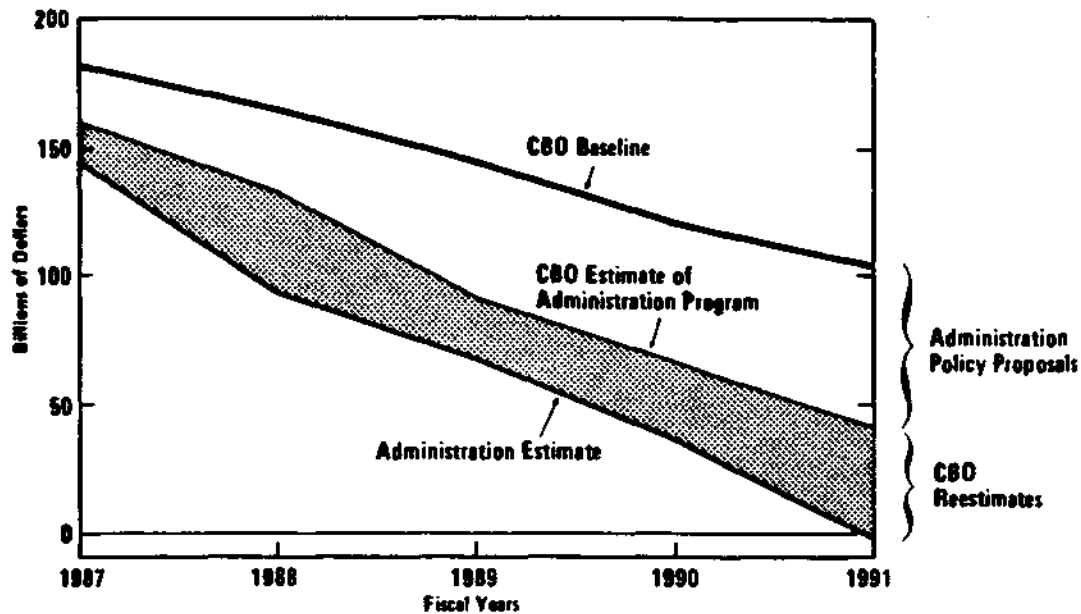
	1986	1987	1988	1989	1990	1991
Revenues						
Administration						
Estimate	777.1	850.4	933.2	996.1	1,058.1	1,124.0
CBO Estimate	778.7	849.9	928.1	999.9	1,074.8	1,150.2
Outlays						
Administration						
Estimate	979.9	994.0	1,026.8	1,063.6	1,093.8	1,122.7
CBO Estimate	983.5	1,009.7	1,060.3	1,091.4	1,141.3	1,190.2
Deficit (-) or Surplus						
Administration						
Estimate	-202.8	-143.6	-93.6	-67.5	-35.8	1.3
CBO Estimate	-204.7	-159.7	-132.3	-91.4	-66.6	-40.1
Deficit Targets	<u>b/</u>	-144.0	-108.0	-72.0	-36.0	0

SOURCE: Congressional Budget Office; Office of Management and Budget.

- a. Includes Social Security revenues and outlays, which are off-budget.
- b. The Balanced Budget Act set a target of \$171.9 billion in fiscal year 1986, but limited the sequestration to \$11.7 billion.

Figure 1.

Federal Deficit Projections*



SOURCE: Congressional Budget Office; Office of Management and Budget.

* Includes Social Security, which is off-budget.

CBO has reestimated the Administration's deficit figures for two main reasons. First, CBO assumes a lower rate of real economic growth and, until 1991, higher inflation-adjusted interest rates than does the Administration. (CBO and Administration economic assumptions are compared in Chapter I of our report.) Second, based on the historical relation between appropriations and outlays, CBO estimates that spending for national defense will be significantly greater than shown in the President's budget.

Table 2 shows the CBO reestimates of the Administration's budget. The CBO reestimates add \$16.1 billion to the projected deficit in 1987, \$38.7 billion in 1988, and \$41.4 billion in 1991. In 1987 and 1988, technical

differences between CBO and the Administration predominate. Differences in economic assumptions are more important thereafter. Table 3 summarizes the major economic assumptions used by CBO and the Administration.

TABLE 2. CBO REESTIMATES OF THE ADMINISTRATION'S BUDGETARY PROPOSALS (By fiscal year, in billions of dollars) a/

	1986	1987	1988	1989	1990	1991
Deficit						
President's Budget	202.8	143.6	93.6	67.5	35.8	-1.3 <u>b/</u>
CBO Reestimates						
Economic						
Revenues	2.2	-1.7	-4.2	1.2	11.1	21.9
Outlays	-1.3	-2.3	3.8	14.5	28.6	46.3
Deficit	-3.5	-0.6	8.0	13.3	17.5	24.4
Technical						
Revenues	-0.6	1.2	-0.9	2.7	5.5	4.2
Outlays	4.8	17.9	29.8	13.3	18.9	21.2
Deficit	5.4	16.7	30.7	10.6	13.3	17.0
Total Reestimates	1.9	16.1	38.7	23.9	30.8	41.4
Deficit, President's Budget as Estimated by CBO	204.7	159.7	132.3	91.4	66.6	40.1

SOURCE: Congressional Budget Office.

- a. Includes Social Security revenues and outlays, which are off-budget. On-and off-budget totals are shown in Table 5.
- b. Surplus.

TABLE 3. COMPARISON OF ADMINISTRATION AND CBO ECONOMIC ASSUMPTIONS, 1986-1991 (By calendar year)

Economic Variable	Actual 1985	1986	1987	1988	1989	1990	1991
Nominal GNP (billions of current dollars)							
Administration	3,993	4,274	4,629	4,995	5,359	5,709	6,036
CBO	3,993	4,269	4,583	4,930	5,313	5,725	6,152
Real GNP (percent change, year over year)							
Administration	2.3	3.4	4.0	4.0	3.9	3.6	3.5
CBO	2.3	3.2	3.1	3.3	3.5	3.5	3.2
Consumer Price Index <u>a/</u> (percent change, year over year)							
Administration	3.5	3.5	4.1	3.7	3.3	2.8	2.1
CBO	3.5	3.4	4.2	4.4	4.4	4.3	4.3
GNP Deflator (percent change, year over year)							
Administration	3.3	3.5	4.2	3.7	3.3	2.8	2.1
CBO	3.3	3.6	4.1	4.1	4.1	4.1	4.1
Three-Month Treasury Bill Rate (percent)							
Administration	7.5	7.3	6.5	5.6	4.8	4.3	4.0
CBO	7.5	6.8	6.7	6.4	6.1	5.7	5.4
Ten-Year Government Bond Rate (percent)							
Administration	10.6	8.9	8.5	7.3	5.5	4.8	4.5
CBO	10.6	9.0	8.9	8.2	7.5	6.8	6.1
Civilian Unemployment Rate (percent)							
Administration <u>b/</u>	7.2	6.7	6.5	6.3	6.1	5.8	5.6
CBO	7.2	6.7	6.7	6.5	6.3	6.1	6.0

SOURCE: Congressional Budget Office

- a. Urban wage and clerical workers.
- b. The Administration's projection is for the total labor force including armed forces residing in the United States, while CBO's is for the civilian labor force excluding armed forces. In recent years, the former has tended to be 0.1 to 0.2 percentage points below the rate for the civilian force alone.

CBO's economic assumptions reduce the estimated deficit slightly in 1986 and 1987, but they add to the deficit estimates by increasing amounts thereafter. In 1991, CBO's estimate of the deficit is \$24.4 billion higher than that of the Administration because of differing economic assumptions. CBO's economic assumptions add to both revenues and outlays as a result of higher rates of inflation than the Administration assumes. Because CBO assumes lower real growth and higher real interest rates than the Administration, however, the addition to outlays is greater than the addition to revenues.

CBO's real growth projection is based on average economic growth for nine-year periods following recession troughs. On average, since World War II, the annual growth rate of real GNP over such nine-year periods has been 3.7 percent, and the CBO projection closely approximates that result. The Administration's projection for real growth is not much higher for any one year and is well within the range of historical experience. By 1991, however, the level of real gross national product assumed by the Administration is about 2½ percent higher than in CBO's projection.

Both the Administration and CBO assume a decline in nominal and real (inflation-adjusted) interest rates over the 1987-1991 period. By 1991, both assume a Treasury bill rate between one and two percentage points above inflation--about equal to the average over the past 30 years. But the CBO assumptions envision real interest rates declining gradually to this level,

while the Administration assumes that inflation-adjusted rates return much more quickly to their historical averages.

Technical estimating differences between CBO and the Administration add an average of \$18 billion per year to the projected deficits. Of this amount, about \$14 billion per year involves national defense. Each year the Congress appropriates new budget authority, which allows the Department of Defense to enter into spending obligations. But these obligations may not result in cash outlays for some years. CBO uses historical spending rates to estimate the amount of outlays that will occur each fiscal year from given levels of budget authority. The Administration, however, believes that historical defense spending patterns will not apply in the future.

Other technical estimating differences, in total, increase both estimated revenues and outlays. On the revenue side, the differences between CBO and the Administration are small and, for the most part, offsetting. About half derive from differences in estimates of proposed legislation and administrative actions. Most of the remaining differences on the outlay side result from the higher net interest costs necessitated by other technical reestimates to revenues and outlays. These additional debt service costs add \$20 billion over the 1987-1991 period. CBO and the Administration also differ in their estimates of farm price supports, Outer Continental Shelf escrow releases, and the proceeds from sale of the Naval Petroleum Reserves and Power Marketing Administrations.

THE ADMINISTRATION'S BUDGET PROGRAM

CBO's baseline projections provide a benchmark against which the Administration's budget program can be measured. The baseline generally assumes that defense and nondefense appropriations are held constant in real terms and that tax and entitlement laws are continued unchanged. Under these assumptions, CBO projects that the federal deficit will fall from \$208.3 billion in 1986 to \$181.3 billion in 1987 and \$104.3 billion in 1991. The baseline projections are described in more detail in CBO's recent annual report, The Economic and Budget Outlook: Fiscal Years 1987-1991.

As in recent years, the Administration proposes to increase defense spending above baseline levels and to reduce the deficit primarily through large cuts in domestic programs. The deficit reductions amount to \$21.6 billion in 1987 and rise to \$64.2 billion in 1991. Over the entire 1987-1991 period, the Administration's proposals would reduce the deficit by a total of \$224.1 billion (see Table 4).

The Administration is proposing roughly 6 percent real growth in defense appropriations in 1987 and an annual average of about 3 percent real growth over the 1987-1991 period. This policy would increase defense spending by \$12.7 billion in 1987 and \$120.6 billion over five years above the CBO baseline, which assumes no real growth in defense. To allow for this

growth in defense and to reduce the deficit, the required cuts in nondefense spending and increase in revenues total \$34.3 billion in 1987 and \$344.7 billion over five years.

TABLE 4. THE ADMINISTRATION'S DEFICIT REDUCTION PROGRAM AS ESTIMATED BY CBO (By fiscal year, in billions of dollars) a/

Major Program	1987	1988	1989	1990	1991	Cumulative Five-Year Changes
CBO Baseline Deficit	181.3	164.9	143.6	120.1	104.3	
Proposed Changes						
Revenues	-5.9	-7.1	-8.6	-7.2	-6.5	-35.4
Outlays						
National defense	12.7	20.2	25.1	29.6	32.9	120.6
Entitlements and other mandatory spending	-15.2	-20.3	-23.2	-26.7	-30.1	-115.5
Nondefense discre- tionary spending	-8.7	-16.0	-26.3	-32.7	-40.6	-124.3
Offsetting receipts	-4.1	-7.9	-14.8	-9.1	-9.2	-45.2
Net interest	-0.2	-1.7	-4.4	-7.4	-10.7	-24.4
Subtotal, outlays	<u>-15.6</u>	<u>-25.6</u>	<u>-43.5</u>	<u>-46.3</u>	<u>-57.7</u>	<u>-188.7</u>
Total Policy Changes	-21.6	-32.7	-52.1	-53.6	-64.2	-224.1
President's Budget as Estimated by CBO	159.7	132.3	91.4	66.6	40.1	
President's Budget	143.6	93.6	67.5	35.8	-1.3 <u>b/</u>	
CBO Reestimates	16.1	38.7	23.9	30.8	41.4	150.9

SOURCE: Congressional Budget Office; Office of Management and Budget.

- a. Includes Social Security revenues and outlays, which are off-budget.
- b. Surplus.

For the entire five-year period, the Administration's policy proposals imply:

- o \$35.4 billion in higher revenues. More than half of this amount--\$19.4 billion--results from increased Internal Revenue Service (IRS) staff and other IRS initiatives. Extension of the cigarette tax increase of 8 cents per pack will generate \$9.3 billion. Increasing the federal employee contribution to Civil Service Retirement from 7 percent to 9 percent of earnings will bring in an additional \$5.6 billion.
- o \$115.5 billion in reductions in entitlement programs. The cuts are similar to last year's Administration proposals. The largest reductions--\$45.6 billion--would be targeted on Medicare and Medicaid. General Revenue Sharing would be eliminated, thereby saving \$22.5 billion. Federal employee retirement and health benefits would be cut by \$17.7 billion, child nutrition and food stamps by \$7.3 billion, and guaranteed student loans by \$7.2 billion. No reductions are proposed in Social Security, unemployment compensation, or veterans benefits. Only small cuts would be made in means-tested, income transfer programs.
- o \$124.3 billion in lower nondefense discretionary spending. Among the largest proposed reductions are transportation programs

(\$17.4 billion), Farmers Home Administration direct loans (\$15.2 billion), civilian agency pay raises (\$13.4 billion), housing assistance (\$14.5 billion), health education and research (\$8.8 billion), training, employment, and social services (\$8.4 billion), Pell Grants for needy college students (\$8.2 billion), and elementary and secondary education (\$6.8 billion). Increases are proposed for international affairs, science and space, and the Internal Revenue Service.

- o \$45.2 billion in increased offsetting receipts. About \$18 billion would come from increases in premiums charged to participants in Supplementary Medical Insurance (Part B of Medicare). Over \$12 billion would result from fees charged to users of government services, such as navigation and boating assistance, customs and meat inspection, park and forest recreation, and government-sponsored enterprises. (Some proposed user fees are included in revenues and in other spending categories.) The sale of five Power Marketing Associations and the Naval Petroleum Reserves would raise, net of forgone receipts, about \$11 billion.

- o \$24.4 billion in reduced net interest costs would result from the other policy changes.

The Administration's proposed revenue and spending changes are described in detail and analyzed in Chapters II through IV of our report.

As in last year's budget, the Administration proposes to transfer certain federal activities to state and local governments and to reduce federal involvement in credit markets. Of the \$309 billion in proposed nondefense outlay reductions, \$92 billion--or 30 percent--would come from grants to state and local governments. Many grant programs are targeted for elimination, notably General Revenue Sharing (\$22.5 billion in cuts) and grants for the construction of sewage treatment plants (\$2.9 billion). Others would be subject to large reductions, including education, training, and social services (\$17.0 billion), Medicaid (\$10.0 billion), federal-aid highways (\$5.5 billion), other transportation grants (\$8.5 billion), and housing assistance (\$8.1 billion). Under the Administration's proposals, federal grants would represent 1.7 percent of gross national product (GNP) in 1991, as compared with 2.7 percent of GNP in 1985 and 3.4 percent of GNP as recently as 1980.

The Administration proposes to cut federal direct lending over the next five years by one-quarter, or \$44.6 billion. Eliminating Farmers Home Administration and Small Business Administration direct loans would account for \$28 billion of this reduction. The volume of federally guaranteed loans would also be reduced by restricting eligibility and lowering the amount of subsidy. A more detailed overview of the Administration's credit proposals is given in Appendix A.

The proposed increases in defense and the cuts in nondefense programs would change the composition of federal spending as set forth in

Table 5 and Figure 2. With 3 percent real growth, defense outlays would grow only slightly less rapidly than CBO's projection of GNP. National defense spending would absorb 6.4 percent of GNP in 1987 and 6.2 percent in 1991. In the CBO baseline, which assumes no real defense growth, the 1991 defense share is only 5.7 percent of GNP.

The budget proposals would accelerate the projected decline in non-defense spending. Nondefense discretionary spending currently represents 4.1 percent of GNP, about the same share as it did 25 years ago. In the baseline it declines to 3.4 percent of GNP by 1991, and under the Administration program it would fall to 2.7 percent. Spending for Social Security and Medicare benefits is projected to rise slightly in the baseline relative to GNP but remains constant under Administration policy. Other entitlements and mandatory spending are projected to decline from their current level of 4.4 percent of GNP, but the drop is greater under the President's proposals.

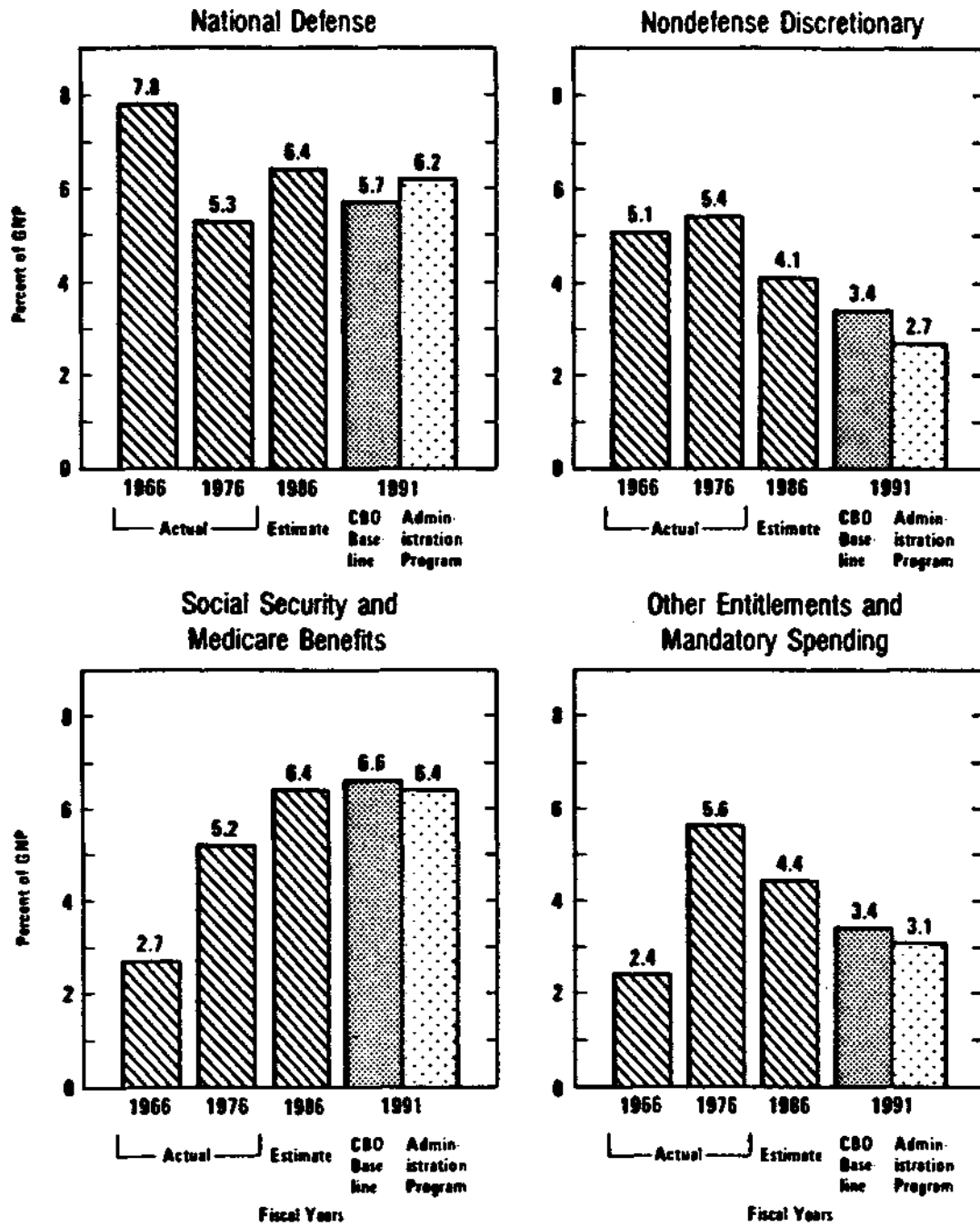
TABLE 5. CBO ESTIMATES OF THE ADMINISTRATION'S BUDGET PROGRAM (By fiscal year) a/

	1986	1987	1988	1989	1990	1991
In Billions of Dollars						
National Defense	269.5	296.7	316.6	336.1	356.5	376.9
Entitlements and Other						
Mandatory Spending	452.7	458.3	488.7	513.2	539.8	573.9
Nondefense Discretionary	172.0	165.6	166.7	162.1	163.2	163.4
Net Interest	139.8	144.7	152.7	153.2	151.7	149.6
Offsetting Receipts	<u>-50.5</u>	<u>-55.6</u>	<u>-64.3</u>	<u>-73.3</u>	<u>-69.9</u>	<u>-73.6</u>
Total Outlays	983.5	1,009.7	1,060.3	1,091.4	1,141.3	1,190.2
Revenues	778.7	849.9	928.1	999.9	1,074.8	1,150.2
Deficit	204.7	159.7	132.3	91.4	66.6	40.1
Debt Held by the Public	1,716.6	1,875.3	2,006.6	2,097.0	2,162.6	2,201.7
As a Percent of GNP						
National Defense	6.4	6.6	6.5	6.4	6.3	6.2
Entitlements and Other						
Mandatory Spending	10.8	10.2	10.1	9.8	9.6	9.5
Nondefense Discretionary	4.1	3.7	3.4	3.1	2.9	2.7
Net Interest	3.3	3.2	3.2	2.9	2.7	2.5
Offsetting Receipts	<u>-1.2</u>	<u>-1.2</u>	<u>-1.3</u>	<u>-1.4</u>	<u>-1.2</u>	<u>-1.2</u>
Total Outlays	23.5	22.4	21.9	20.9	20.3	19.7
Revenues	18.6	18.9	19.2	19.2	19.1	19.0
Deficit	4.9	3.5	2.7	1.8	1.2	0.7
Debt Held by the Public	41.0	41.6	41.5	40.2	38.5	36.4
Memorandum: GNP	4,192	4,504	4,838	5,214	5,619	6,047

SOURCE: Congressional Budget Office.

a. Includes Social Security revenues and outlays, which are off-budget. On-and off-budget totals are shown in Table 5.

Figure 2.
The Composition of Federal Spending



SOURCE: Congressional Budget Office.