Statement of
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before the
Committee on Ways and Means
U.S. House of Representatives

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NOTICE

This statement is not available for public release until it is delivered at 10:00 a.m. (EST), Thursday, February 9, 1989.

Mr. Chairman, I am pleased to appear before the committee this morning to discuss the federal budget outlook and the economic consequences of large budget deficits. These important issues are discussed in detail in the Congressional Budget Office (CBO) report entitled *The Economic and Budget Outlook: Fiscal Years 1990-1994*, which was released late last month. My testimony today will cover three major areas discussed in that report:

- The budget outlook;
- The economic consequences of large deficits; and
- Fiscal policy and the financing of Social Security.

THE BUDGET DEFICIT: THE OUTLOOK AND SOME HISTORICAL PERSPECTIVE

CBO now estimates the budget deficit for 1989 to be $159 billion, slightly higher than it was in 1988. Under current budgetary policies, the deficit is projected to decline slowly thereafter--to $146 billion in 1990 and 1991, $140 billion in 1992 and $130 billion in 1994--as shown in Table 1. These figures exceed by increasing amounts the deficit targets specified in the Balanced Budget Reaffirmation Act of 1987, which calls for a balanced budget by 1993. The budget baseline is estimated using methods prescribed in the Reaffirmation Act. It projects revenues, offsetting receipts, and entitlement spending under current laws, while defense and nondefense discretionary appropriations are held constant in real terms. To reflect new information provided in the President's budget and elsewhere, the budget estimates presented here have been slightly revised from those in our recent report (*The Economic and Budget Outlook*).

The size of future budget deficits depends heavily on how the economy will perform, particularly in the areas of economic growth, inflation, and interest rates.

TABLE 1. BASELINE BUDGET PROJECTIONS AND UNDERLYING ASSUMPTIONS

	1988	1989	1990	1991	1992	1993	1994
Budget Projections (By fiscal year)							
In Billions of Dollars[a]							
Revenues	909	983	1,069	1,140	1,209	1,280	1,359
Outlays	1,064	1,142	1,215	1,287	1,348	1,416	1,489
Deficit	155	159	146	146	140	135	130
Deficit Targets[b]	144	136	100	64	28	0	--
As a Percentage of GNP[a]							
Revenues	19.0	19.2	19.6	19.6	19.5	19.5	19.4
Outlays	22.3	22.3	22.3	22.1	21.8	21.5	21.2
Deficit	3.2	3.1	2.7	2.5	2.3	2.1	1.9
Economic Assumptions (By calendar year)							
GNP (Billions of current dollars)	4,859	5,209	5,542	5,902	6,281	6,685	7,117
Real GNP Growth (Percent change)	3.8	2.9	2.1	2.2	2.2	2.3	2.3
Implicit GNP Deflator (Percent change)	3.4	4.2	4.2	4.2	4.1	4.1	4.1
CPI-W (Percent change)	4.0	4.9	4.9	4.6	4.4	4.4	4.4
Civilian Unemployment Rate (Percent)	5.5	5.5	5.5	5.5	5.6	5.6	5.6
Three-Month Treasury Bill Rate (Percent)	6.7	7.9	7.1	6.7	6.4	6.1	5.9
Ten-Year Government Note Rate (Percent)	8.9	9.3	9.0	8.6	8.1	7.7	7.4

SOURCE: Congressional Budget Office.

a. The baseline projections include Social Security, which is off-budget.

b. The Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987 established targets for 1988 through 1993.

In CBO's view, the economy is now close to a full use of its productive resources. It is unlikely, therefore, that sustained rapid economic growth will occur and provide a means of closing the gap between outlays and receipts. With the economy operating at such high levels of capacity, the prospect of lower inflation appears remote. Moreover, because of the Federal Reserve's stated intention to restrain the economy, sharp declines in nominal interest rates are not likely in the near term.

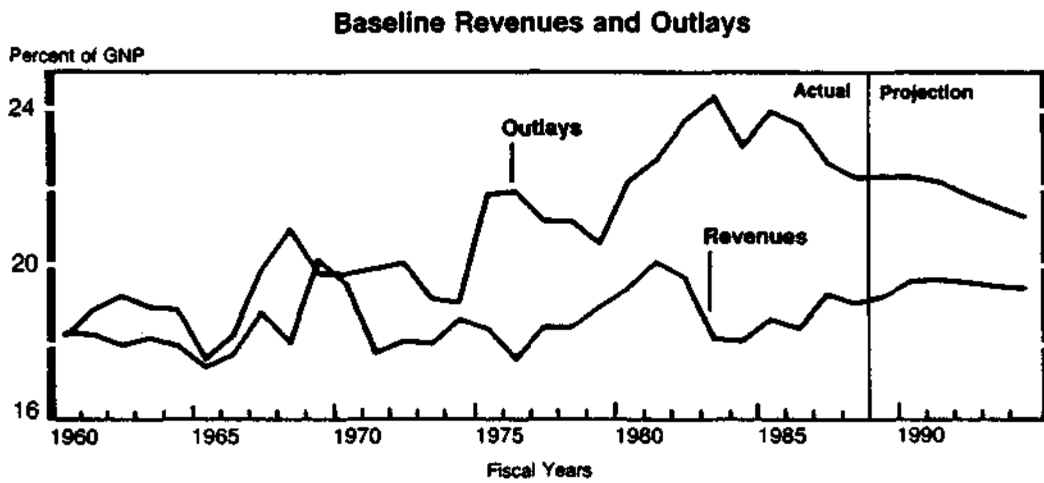
As shown in Figure 1, the federal deficit has recently declined as a percentage of GNP, after rising sharply in the early 1980s. In the 1970s, the deficit averaged about 2 percent of GNP, but in the 1980s the deficit share has averaged about 4 percent. The deficit peaked in 1983 at about 6 percent of GNP, and has since declined to approximately 3 percent. Under the CBO baseline, the deficit-to-GNP ratio declines gradually to about 1.9 percent in 1994. The federal debt-to-GNP ratio is currently at or near a peak, and would fall gradually during the projection period (see Figure 2).

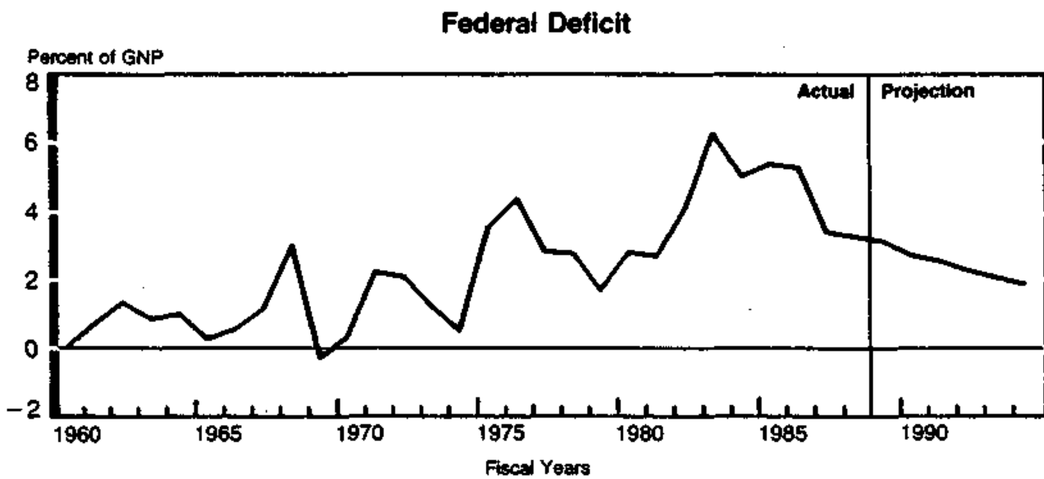
Some analysts conclude that because the deficit has recently declined significantly as a share of GNP, it no longer represents a serious problem. This view overlooks, however, the amount of private saving that the deficit is absorbing. Because domestic private saving has recently declined as a percentage of national income, the deficit is still absorbing as large a share of saving as in the early 1980s.

ECONOMIC CONSEQUENCES OF LARGE DEFICITS

The high rate at which domestic saving is being absorbed is the primary reason for concern about sustained large budget deficits. This high rate means that the deficit restricts national saving and investment, thereby reducing economic growth and with it the growth of living standards for later generations. Sustained deficits also

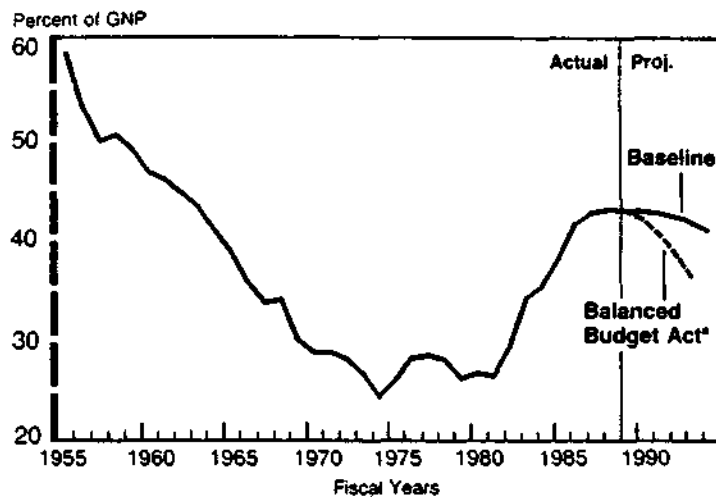
Figure 1. Federal Budget Measures





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

Figure 2. Publicly Held Federal Debt



[a] These projections assume full implementation of whatever deficit reductions are needed to achieve the budget targets for 1990 through 1993 set forth in the Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987.

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

raise interest rates, increase the trade deficit, and increase the likelihood of severe swings in financial markets.

Effect of Deficits on Saving, Investment, and Living Standards

Net saving and investment have declined significantly as shares of national income in the 1980s, and the federal deficit has been a significant factor. Since 1980, net national saving has averaged only 3.5 percent of net national product (GNP less capital depreciation) compared with 8.0 percent in the 1952-1979 period. Net domestic investment has also declined in the 1980s to 5.2 percent of net national product (NNP), compared with 7.6 percent in the 1952-1979 period. A net inflow of foreign capital has made up this discrepancy between saving and investment.

One can attribute the decline in the national saving rate about equally to declines in the net private saving rate and in the saving rate of the public sector. As Figure 3 shows, the private saving rate has fallen sharply during the 1980s. Moreover, according to most analyses of private saving, no significant improvement is likely soon. At the same time, as shown in Figure 4, the public saving rate has also fallen dramatically as a result of the rise in the federal deficit. Thus, absorption of saving by the public sector--the federal deficit less state and local government surpluses--has been a major factor in the recent decline of the national saving rate.

These trends in saving and investment are especially worrisome because recent rates of productivity growth and demographic factors imply that American living standards may improve less rapidly during the next half-century than in the past. A low national saving rate makes the slowdown worse. In large part, this slower growth will be caused by the retirement of the baby-boom generation early in the next century. A smaller part of the population will be working then, and what they

Figure 3. Net Private Saving as a Share of Net National Product

SOURCES: Congressional Budget Office; Federal Reserve Board; Department of Commerce, Bureau of Economic Analysis.

NOTE: Net private saving is private saving less depreciation of capital.

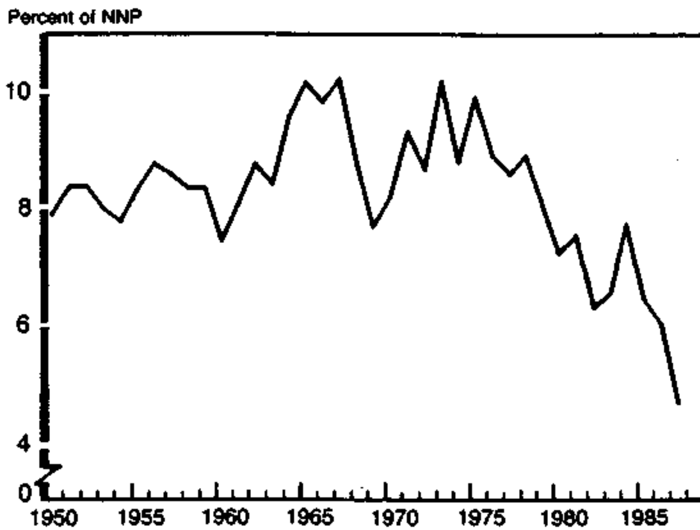
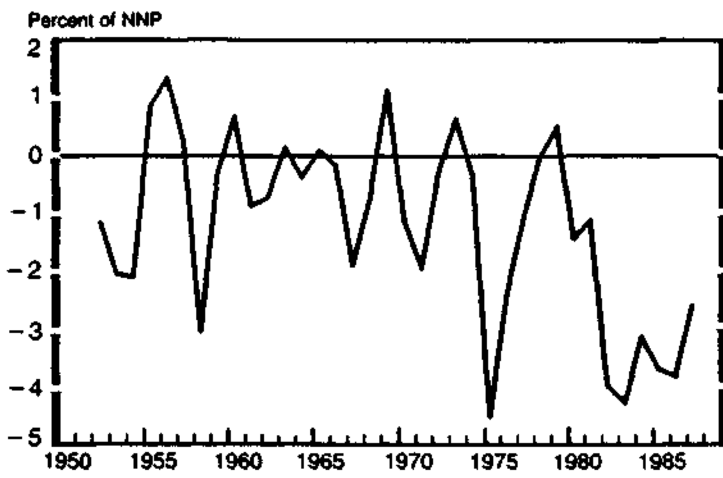


Figure 4.
Public Saving as a Share of Net National Product

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

NOTE: Public saving is the sum of federal, state, and local government saving.



earn will have to be shared with the increasing part of the population who will be retired. As a result, consumption per capita may grow significantly more slowly during the next half-century than during the last fifty years. Moreover, if saving rates and growth of productivity were to remain below historical averages, as they have recently, consumption per person would grow even more slowly.

Reducing the budget deficit would be the most direct way to increase saving. Policy measures may not be very effective in raising the private saving rate. Most proposed measures to increase private saving involve raising its after-tax real return--by cutting tax rates, for example. There is little evidence, however, that saving is responsive to the size of its return. During the first half of the 1980s, for instance, real interest rates rose sharply compared with the 1970s, marginal tax rates were cut, and several other policy measures were adopted to encourage saving. The private saving rate, however, failed to rise.

Significant deficit reductions can improve the outlook for increasing living standards. Recent analysis by CBO, which is described in our annual report, suggests that reducing the federal budget deficit beyond the reductions mandated in the Reaffirmation Act could raise consumption over the longer run. If the federal government were to run a surplus of 2 percent of GNP after 1993 instead of a balance, private and public consumption would initially be reduced by a little more than 2 percent, as the government reduced spending or increased taxes. But the higher saving would raise capital accumulation and output, and would eventually increase incomes and consumption. By the year 2040, for example, the increase in per capita consumption would be between 2 percent and 14 percent relative to what it would have been without the federal budget surplus assumed in the calculation. In CBO's view, the effect would be somewhere in the middle of this range.

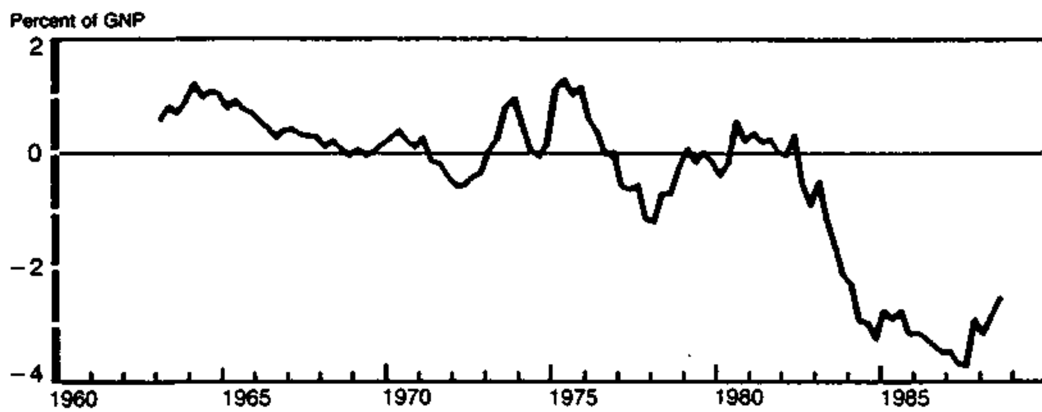
How the deficit is reduced can have some impact on the gains in living standards that ultimately result. Certain federal expenditures on public investment --such as infrastructure, education, or research and development--may do as much as private investment to increase output, and could be given priority for that reason. If taxes have to be raised, however, most methods of broadening the tax base would better serve the process of encouraging economic growth than would an increase in marginal income tax rates. Other possibilities include a broad-based consumption tax, which could encourage saving, or an increase in excise taxes. An increase in the gasoline tax could, in addition to raising revenues, encourage conservation.

Effects of the Budget Deficit on the Trade Deficit

During the 1980s, the United States has experienced unusually large trade deficits, and an associated massive buildup of net U.S. debt to the rest of the world. The trade deficits are the products of several factors acting together, but the budget deficit is one of the main factors. As Figure 5 shows, the U.S. nominal trade deficit finally started to improve in 1987 and 1988. Recently, the improvement appears to have slowed, though CBO's analysis suggests that it will start to improve again if the dollar depreciates significantly further as the CBO projection assumes.

Reducing the budget deficit could play a critical role in reducing our trade problems. It could help lower the trade deficit by reducing domestic demand for imports, by freeing resources that could be used to expand exports, and by helping to cause the exchange rate to depreciate somewhat further. A budget deficit reduction path, like that contained in the Reaffirmation Act, would significantly improve the trade deficit over a period of several years.

Figure 5. Current Account Surplus



SOURCES: Congressional Budget Office; Department of Commerce, Bureau of the Census, Bureau of Economic Analysis.

Effects of the Buildup of External Debt

The buildup in the net U.S. debt to the rest of the world reached approximately one-half trillion dollars by the end of 1988, and is expected to reach $1 trillion by the mid 1990s. This buildup of debt brings with it two major economic problems: it means that increasing amounts of domestic income must be sent abroad as interest and dividends on foreign investments in this country, and that the United States faces an increased risk of a sharp decline in the dollar and a rise in interest rates. Some economists argue that these swings in interest and exchange rates could be severe enough to cause a recession.

The cost of servicing the foreign debt is mounting. At the beginning of the 1980s, the United States had net earnings on its foreign investments of about $35 billion per year. By 1988, however, the net earnings had gone, and we were instead paying abroad about $3 billion per year. If the net foreign debt grows to $1 trillion by the mid-1990s, as CBO currently projects, the cost of servicing the foreign debt could amount to some one-half percent of gross domestic product.

This buildup of external debt also poses increased risks to the U.S. economy. For one thing, foreign private investors and central banks may be increasingly unwilling to continue to finance U.S. current-account deficits. Inducing private investors to devote larger and larger amounts of their wealth to dollar investments may require progressively higher interest rates, as well as continued expectations that the exchange rate will not depreciate sharply.

Another risk is that foreign central banks may not be as willing to help finance our trade deficit as they have in the recent past. In the last few years, central banks abroad have at times devoted large sums to supporting the dollar. If this pattern

continues, their countries could suffer potentially inflationary increases in their own domestic money supplies as a result.

Effect of Deficits on Interest Rates

Many analysts argue that large federal deficits are partly responsible for the unusually high levels of inflation-adjusted interest rates during the 1980s. The real 91-day Treasury bill rate has averaged 4.4 percent since 1980, compared with its average over the entire post- World War II period of 0.7 percent. The increased budget deficits during this period could have helped to raise rates by increasing competition with private demands for credit.

Economists do not agree on just how much interest rates would fall if the deficit were reduced. The decline in rates could be less dramatic than some have suggested because of the changes in net international capital flows that it might cause. In effect, the decline in interest rates may be attenuated because the effects are spread worldwide. The best chance of causing a large decline in long-term rates would come from a large and highly credible deficit reduction, perhaps phased in over more than one year. This approach stands the best chance of changing expectations in financial markets, which play a large role in setting long-term rates.

At the request of the National Economic Commission, CBO recently simulated the effects of reducing the budget deficit on interest rates using large-scale econometric models. Each package analyzed consisted of a multiyear program of reductions totaling $120 billion to $130 billion per year by 1994. This analysis suggested that the real interest rate might be about one and one-half percentage points lower on average over the five-year period, compared with the current baseline in the models. The reduction would be smaller in relation to CBO's

baseline as shown in Table 1. These estimates also incorporate the effects of easing monetary policy. They are near the middle of the range obtained by other researchers using a variety of estimating techniques that take account of such refinements as effects of deficit reduction on the world economy and the implications of rational expectations.

The above estimates could understate the impact of deficit reduction on long-term interest rates if a large, multiyear deficit reduction is enacted. Some analysts have obtained substantially larger effects on long-term rates by using analytic methods that emphasize rapid changes in expectations, such as those that could bring long-term rates down sharply. On the other hand, as I discussed earlier, there is a risk that the decline in interest rates may be smaller because of the response of international capital flows and the trade deficit. Thus, a major benefit from reducing the budget deficit may be an improvement in the balance of payments, rather than a large effect on interest rates. Many analysts stress the effects on the balance-of-trade, and above all the effects on long-term economic growth, as the principal benefits from reducing the deficit.

Short-Run Effects of Cutting the Deficit on Aggregate Demand

My testimony so far has focused primarily on the long-run consequences of fiscal policy. I have argued that reducing the deficit and eventually running a budget surplus would increase long-run growth by increasing saving and investment. But I should also point out that in the short-run reducing the deficit can temporarily have the opposite effect on economic growth--that is, it can reduce aggregate demand and cause unemployment to rise. Some policymakers are especially concerned that, with

the expansion beginning its seventh year, now may not be an opportune time to reduce fiscal deficits.

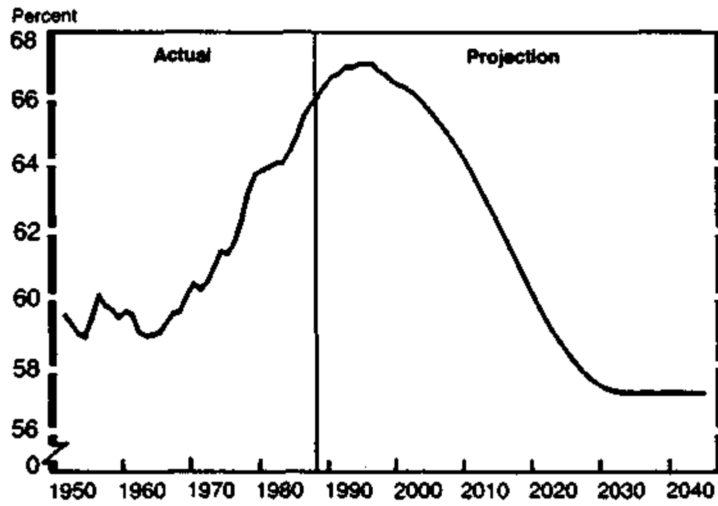
In the current circumstances, however, it seems unlikely that deficit reductions of the magnitude contemplated in the Reaffirmation Act would run a major risk of causing the economy to be too weak. Aggregate demand has recently been too strong to suit the Federal Reserve, and has prompted significant monetary restraint. Significant deficit reduction could make less monetary restraint possible. In addition, a budget plan that convincingly sets a course of declining deficits over several years could, as I explained earlier, have a quick and substantial effect on exchange rates and long-term interest rates. That effect, in turn, could stimulate other sectors of the economy and help avoid causing an economic slowdown.

FISCAL POLICY AND THE FINANCING OF SOCIAL SECURITY

Some arguments for reducing the deficit are bound up with developments involving expected changes in the age composition of the population. As Figure 6 illustrates, the Social Security Administration's long-term demographic projections indicate that the share of the adult population (ages 16 and older) in the labor force will begin a permanent decline at about the turn of the century as the baby-boom generation reaches retirement age.

These long-term projections are valuable because they illustrate the need to plan ahead for the major rise in the ratio of people who are dependent. A major implication of this change is that the economy and the population who are then working will have to support a large retired population. Some analysts argue that we should start saving and investing more in the near term so that more capital and income will be available to ease this transition and to help support a much larger

Figure 6. Labor Force as a Share of the Adult Population



SOURCES: Congressional Budget Office; Social Security Administration.

retired population. As I mentioned earlier, such calls for increased national saving usually take the form of recommendations that the federal budget deficit be reduced.

The Social Security trust fund is currently running a surplus of over $50 billion per year as a result of the Social Security reforms of 1977 and 1983. Because of past and projected surpluses, the projected buildup in Social Security balances is very large--from slightly over $100 billion at the end of 1988 to about $9.1 trillion by the year 2020. By that time, program outlays will exceed payroll tax receipts for Social Security. As a result, the overall federal deficit will grow sharply. Many analysts would argue, therefore, that the right time to increase government saving is during the next 30 years. In that way, fiscal policy would be contributing to capital formation. Later, it will be more difficult.

CONCLUSION

In conclusion, large budget deficits exacerbate several major problems of the economy: a low saving rate; a large trade deficit and mounting foreign debt; and an element of instability in financial markets. The Congress has made significant progress in reducing the fiscal deficit. As a result, the deficit problem has become more chronic than acute. Further substantial cuts in the deficit could have significant long-run effects on growth. Economic analysis can only help inform the debate; it remains, however, essentially a political choice to decide whether the future benefits justify the sacrifices they would entail.