Statement of
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before the
Committee on Appropriations
United States Senate

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Mr. Chairman, I am pleased to present this afternoon the Congressional Budget Office's (CBO's) analysis of the President's budgetary proposals for fiscal year 1986. Copies of our analysis, which was prepared at the request of this Committee, have been distributed to Members and my statement will summarize its findings.

The Administration's budget proposals this year are very different from those of a year ago. The President's 1985 budget did not recommend major policy changes in terms of either revenues or expenditures. This year, the President proposes a major assault on the projected budget deficits by reducing the growth in government spending. CBO estimates that approval of the Administration's proposals would hold the growth in total outlays to 2½ percent in 1986, compared with 13 percent in 1985. Only minor changes are proposed for federal taxes, and total revenues next year are projected to grow by over 7 percent. As a consequence, the total deficit would decline from an estimated $215 billion in the current year to $186 billion in 1986, or roughly the same level as for 1984.

The budget outlook after 1986 depends critically on what assumptions are made about the performance of the economy. Our analysis of the President's budget is made in terms of changes from the CBO baseline budget projections for the 1986-1990 period. These projections were presented in detail a few weeks ago in the first volume of our annual report to the Budget Committees. 1/ They provide a basis for evaluating the "static" or "direct" budgetary impacts of proposed changes in spending and tax provisions--that is, the impacts measured before any consideration is given to changes in the economy that might be caused by the policy changes, and to the impacts such changes in the economy might in turn have on the budget.

Using CBO's economic assumptions, revenues and outlays under the Administration's policy proposals would both grow at about the same rate in 1987-1990, and the deficit would remain at about the $186 billion level throughout the period. Under the Administration's economic assumptions, however, growth in revenues would be greater than growth in expenditures and the deficit would continue to decline steadily, falling below $100 billion in 1990.

THE BUDGET UNDER CURRENT POLICIES

CBO's baseline budget projections assume, for the most part, no changes in current laws governing taxes or entitlement spending. For nondefense spending that is discretionary and subject to annual appropriations, the baseline projections generally assume that the 1985 appropriation levels will be increased to keep pace with inflation. For defense spending, an extrapolation of the 1985 Congressional budget resolution is used as the best approximation of current policy.

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1. See Congressional Budget Office, The Economic and Budget Outlook: Fiscal Years 1986-1990 (February 1985).

Table 1 shows the latest CBO baseline budget projections. The outlay and deficit projections are slight upward revisions of those published earlier this month and reflect additional information about spending patterns gleaned from the President's budget. Most of the changes in the projections are for public enterprise funds--such as the Agricultural Credit Insurance Fund, Rural Housing Insurance Fund, Postal Service Fund, Low-Rent Public Housing Loan Fund, and Loan Guaranty Revolving Fund—where the Executive Branch has considerable freedom of action in administering the programs.

In relation to gross national product, baseline deficits are roughly stable--at about 5.4 percent of GNP. In dollar terms, however, the baseline deficit rises from $220 billion in 1986 to $302 billion by 1990. With deficits of this magnitude, federal debt held by the public would more than double over the next six years. At the end of 1984, debt held by the public equaled $1.3 trillion, or 37 percent of GNP. By the end of 1990, it would reach $2.8 trillion, or 50 percent of GNP—far above its average of 28 percent of GNP during the 1970s.

For comparability with Administration estimates, the baseline projections of outlays and the deficit include spending that is off-budget under current law. The Administration is proposing that programs currently excluded from the unified budget be included in the budget totals. Like the unified budget deficit, the outlays of these off-budget entities must be financed by borrowing from the public. The Congressional Budget Office has long supported a comprehensive federal budget because it portrays most accurately the economic importance of government activities and gives policymakers the greatest control over spending and tax policies.

TABLE 1. CBO BASELINE BUDGET PROJECTIONS (By fiscal year) a/

	1985	1986	1987	1988	1989	1990
			In Billions of Dollars			
Revenues	735	788	855	934	1,005	1,088
Outlays b/	950	1,008	1,095	1,191	1,284	1,390
Deficit b/	215	220	240	257	280	302
Debt Held by the Public	1,526	1,745	1,984	2,240	2,519	2,820
			As a Percent of GNP			
Revenues	19.1	19.0	19.1	19.3	19.3	19.4
Outlays b/	24.6	24.2	24.4	24.7	24.7	24.8
Deficit b/	5.6	5.3	5.4	5.3	5.4	5.4
Debt Held by the Public	39.6	42.0	44.3	46.4	48.4	50.3

a. The baseline figures are revisions of those appearing in Congressional Budget Office, The Economic and Budget Outlook: Fiscal Years 1986-1990 (February 1985).

b. Includes programs that are off-budget under current law.

THE ADMINISTRATION'S BUDGET PROGRAM

The Administration's 1986 budget continues the current trends toward higher defense and lower nondefense spending. The proposed reductions in nondefense outlays are similar in size to those requested by President

Reagan in 1981, and are greater than those requested in any year since. Moreover, the reductions generally consist of specific proposals and do not include, as in past years, unspecified future reductions or management savings targets.

The major elements of the Administration's budget program are listed in Table 2. Over the 1986-1990 period, revenues would be within $4 billion of the CBO baseline. Proposed outlay changes, however, would reduce spending by $364 billion. This reduction is the net effect of $43 billion in defense spending increases, $363 billion in cuts in nondefense spending programs, and a $43 billion reduction in net interest costs resulting from the other spending changes. The proposed reductions in nondefense programs consist of:

- <u>$144 billion in reductions in entitlement programs.</u> The largest reductions--$44 billion--would be targeted on Medicare and Medicaid. Farm price supports would be cut by $32 billion, general revenue sharing by $24 billion, and federal employee retirement by $12 billion. No reductions are proposed in Social Security, unemployment insurance, or veterans' income support and education benefits. Only small cuts would be made in means-tested, income-transfer programs.

- $187 billion in lower nondefense discretionary spending. Fifty percent of these cuts can be found in only six areas--$39 billion from eliminating most direct loans by the Farmers Home Administration, $19 billion from lower civilian agency pay, $14 billion from reduced housing subsidies, $9 billion from halving urban mass transit assistance, $8 billion from ceasing to add oil to the Strategic Petroleum Reserve, and $7 billion from eliminating Export-Import Bank direct lending. Another 20 percent of the savings would be achieved in student financial aid, training and employment assistance, highway grants, small business and rural electric loans, health research, and subsidies to Amtrak and the Postal Service.

- $32 billion in increased offsetting receipts. One-third of this increase would come from fees charged to users of government services such as inland waterways, deep-draft ports, customs inspections, nonemergency boating assistance, and meat inspection. Another third of the increased receipts comes from increasing the premiums charged to participants in Supplementary Medical Insurance (Part B of Medicare). Other proposals include increases in Postal Service payments for employee retirement and the sale of Small Business Administration loan assets and the Conrail system.

TABLE 2. THE ADMINISTRATION'S BUDGET PROGRAM AS ESTIMATED BY CBO (By fiscal year, in billions of dollars)

	1986	1987	1988	1989	1990	Cumulative Five-Year Total
CBO Baseline Deficit a/	220	240	257	280	302	1,299
Policy Changes						
Revenues b/	-1	1	c/	-2	-2	-4
Outlays						
National defense	2	6	11	12	10	43
Entitlements and other mandatory spending	-14	-23	-31	-36	-40	-144
Nondefense discretionary spending a/	-17	-32	-39	-46	-53	-187
Offsetting receipts	-4	-5	-6	-8	-9	-32
Net interest	c/	-3	-7	-13	-21	-43
Subtotal	-33	-56	-71	-91	-113	-364
Total Policy Changes	-33	-55	-71	-93	-116	-368
President's Budget as Estimated by CBO a/	186	185	186	187	187	930

a. Includes programs that are off-budget under current law.

b. Revenue increases are shown with minus signs because they reduce the deficit; revenue decreases, which are displayed with no sign, increase the deficit.

c. Less than $500 million.

The Administration proposes particularly deep cuts in federal credit programs and in grants to state and local governments. Over the 1986-1990 period, subsidized lending by the Farmers Home Administration, Rural Electrification Administration, Export-Import Bank, Small Business Administration, and other agencies would be cut by $80 billion. The savings in credit subsidy costs would be $48 billion. The Administration contends that borrowers under these programs can find alternative sources of credit and that credit subsidies drive up the interest costs of nonsubsidized borrowers.

Grants to state and local governments would be cut by roughly $105 billion. Programs targeted for cuts are revenue sharing and other general purpose fiscal assistance, Medicaid and public assistance, highways and mass transit, education and social services, community development, and sewage treatment plant construction. The Administration argues that many of the programs provide only local benefits and should not be subsidized by the national taxpayer. It also points to the relatively favorable fiscal position of states and localities vis-a-vis the federal government. Under the Administration's proposals, federal grants to states and localities would represent 1.9 percent of GNP in 1990, as compared with 2.7 percent of GNP in 1985, and 3.7 percent in the peak years of 1977 and 1978.

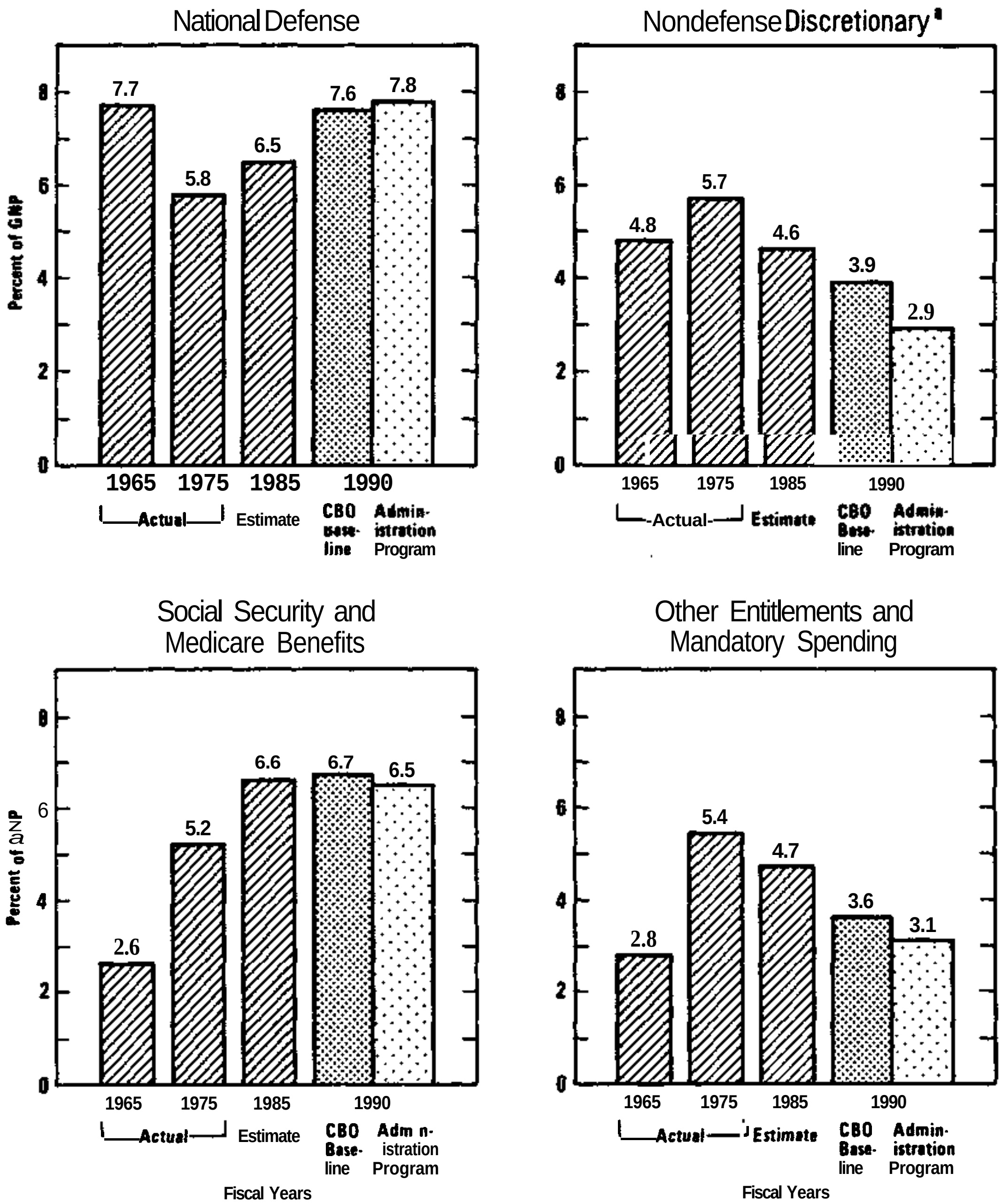
Altogether, nondefense discretionary spending over the 1986-1990 period would be cut 19 percent from CBO baseline levels, while the entitlements would be cut only 6 percent. The proposed increase in defense spending and the cuts in nondefense spending would change the composition of federal spending as set out in Table 3 and Figure 1. Defense spending would grow from $253 billion in 1985 to $435 billion in 1990 and would reach

TABLE 3. CBO ESTIMATES OF THE ADMINISTRATION'S SPENDING PROGRAM BY MAJOR CATEGORY (By fiscal year)

	1985	1986	1987	1988	1989	1990
	In Billions of Dollars					
National Defense	253	284	319	358	396	435
Entitlements and Other Mandatory Spending						
Social Security and Medicare benefits	255	269	290	313	338	365
Other entitlements	182	162	166	167	169	173
Subtotal	437	431	456	481	507	538
Nondefense Discretionary a/	179	167	162	164	164	165
Net Interest	130	146	161	180	195	212
Offsetting Receipts	-48	-54	-59	-64	-68	-73
Total outlays a/	950	975	1,039	1,120	1,193	1,276
	As a Percent of GNP					
National Defense	6.6	6.8	7.1	7.4	7.6	7.8
Entitlements and Other Mandatory Spending						
Social Security and Medicare benefits	6.6	6.5	6.5	6.5	6.5	6.5
Other entitlements	4.7	3.9	3.7	3.5	3.2	3.1
Subtotal	11.3	10.4	10.2	10.0	9.7	9.6
Nondefense Discretionary a/	4.6	4.0	3.6	3.4	3.2	2.9
Net Interest	3.4	3.5	3.6	3.7	3.7	3.8
Offsetting Receipts	-1.2	-1.3	-1.3	-1.3	-1.3	-1.3
Total outlays a/	24.7	23.5	23.2	23.2	22.9	22.8

a. Includes programs that are off-budget under current law.

Figure 1.
The Composition of Federal Spending



[a] Including programs that are off-budget under current law.

SOURCE: Congressional Budget Office.

7.8 percent of GNP, about the same level as in 1965. Nondefense discretionary spending, which is already slightly below its 1965 level, would shrink from its current 4.6 percent of GNP to 2.9 percent of GNP in 1990. Social Security and Medicare benefits would remain a roughly constant share of GNP, but the projected decline in other entitlements and mandatory spending would be accelerated.

CBO's spending reduction estimates are substantially lower than those of the Administration—$33 billion instead of $51 billion in 1986 and $364 billion instead of $507 billion over the 1986-1990 period. Of the $143 billion cumulative difference, $113 billion is definitional and results from using alternative baseline concepts for national defense. As noted earlier, CBO uses the appropriation targets in the most recent Congressional budget resolution (extrapolated from 1988 to 1990) as its defense baseline; defense outlays are estimated consistently with the assumed budget authority using CBO technical estimating methods. In contrast, the Administration measures its defense policy changes from the outlays in the Administration's August 1984 mid-session budget review. The remaining discrepancy of $30 billion in cumulative savings represents other definitional differences, such as treatment of the manned space station and veteran's medical benefits, as well as different estimates of the budgetary effects of the Administration's policy changes. Among the latter, some of the largest are for national defense, farm price supports, and low-income home energy assistance. In addition, the CBO estimate of the President's program adds over $1 billion in outlays each year for nonmilitary economic assistance for Israel. Although the Administration states in the budget document that a request for appropriations will be forthcoming, no money for Israel is included in the budget totals.

CBO REESTIMATES OF THE PRESIDENT'S BUDGET

Almost all of the differences in budget estimates between CBO and the Administration derive from their differing economic assumptions, which are summarized in Table 4. Most of the economic differences result, in turn, from differences in assumed interest rates, which become quite substantial in 1989 and 1990. CBO holds real interest rates constant after 1986; the three-month Treasury bill rate is a flat 8.2 percent from 1987 through 1990. In contrast, the Administration assumes that real interest rates decline steadily after 1987; the Treasury bill rate falls to 5.0 percent by 1990. The different patterns stem in part from the fact that CBO assumes current budgetary policy, while the Administration assumes deficit reductions of $368 billion from 1986 through 1990. The difference in interest rates also reflects the Administration's lower inflation assumptions in 1986 and later years. If the effect of Administration policies were estimated using Administration interest rates, the projected deficit in 1990 would be $65 billion lower than the estimate assuming CBO rates.

The remaining economic differences result from the Administration's assumption of more rapid growth in the gross national product throughout the 1985-1990 period. The Administration's projection of nominal GNP exceeds CBO's by $21 biUion in 1985, $47 biUion in 1986, and growing to

$69 billion in 1990. These GNP differences affect revenues, debt service costs, and, to a minor extent, non-interest outlays by a total of $4 billion in 1986 and $28 billion in 1990.

TABLE 4. COMPARISON OF ADMINISTRATION AND CBO ECONOMIC ASSUMPTIONS, 1985-1990 (By calendar year)

	Actual 1984	1985	1986	1987	1988	1989	1990
Nominal GNP (in billions of dollars)	3661						
Administration		3948	4285	4642	5017	5399	5780
CBO		3927	4238	4567	4921	5301	5711
Real GNP (percent change, year over year)	6.8						
Administration		3.9	4.0	4.0	4.0	3.9	3.6
CBO		3.5	3.2	3.3	3.4	3.4	3.4
Consumer Price Index (percent change, year over year) a/	3.4						
Administration		4.1	4.3	4.2	3.9	3.6	3.3
CBO		3.8	4.5	4.2	4.2	4.2	4.2
91-Day Treasury Bill Rate (percent)	9.5						
Administration		8.1	7.9	7.2	5.9	5.1	5.0
CBO		8.3	8.7	8.2	8.2	8.2	8.2
Civilian Unemployment Rate (percent)	7.5						
Administration b/		7.0	6.9	6.6	6.3	6.1	5.8
CBO		7.1	6.9	6.7	6.6	6.4	6.2

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 labor force.

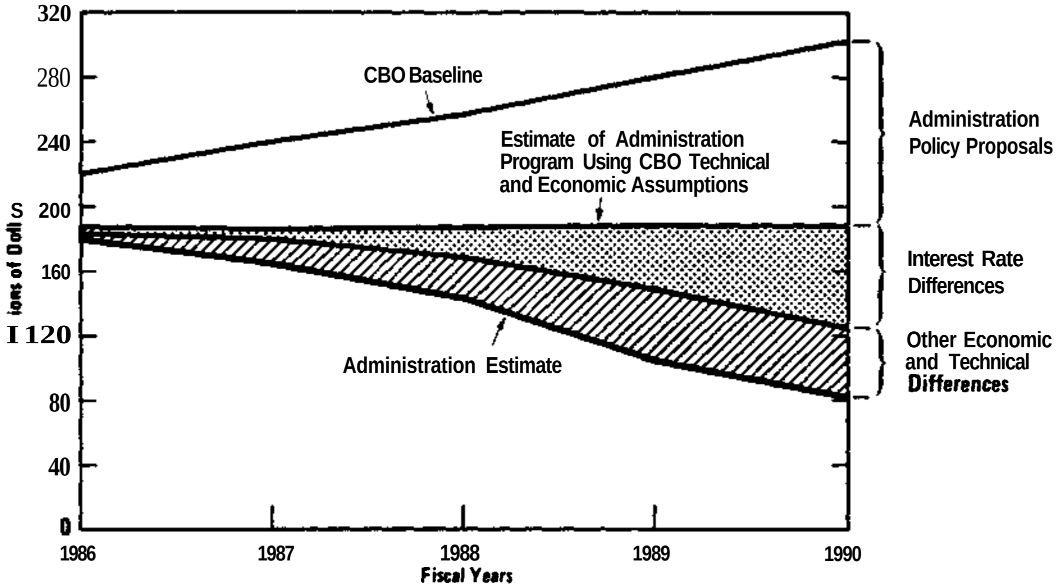
In contrast to recent years, technical differences between CBO and Administration budget estimates are relatively small. CBO would reduce the Administration's 1985 deficit estimate by $9 billion for technical reasons--primarily as a result of lower spending estimates for defense, foreign military sales, nuclear waste fees, Medicare, and Social Security. By 1989 and 1990, however, technical estimating differences cause CBO's deficit projections to exceed the Administration's by $11 billion.

Table 5 and Figure 2 illustrate the effects of the Administration's proposals and of different economic and technical assumptions on the deficit projections. Under current budgetary policies, CBO projects that the deficit would rise from $220 billion in 1986 to $302 billion in 1990. Under the President's program, and using CBO technical and economic assumptions, the deficit would be stabilized at about $186 billion. Using Administration interest rates but other CBO assumptions, the deficit under Administration policies would decline from $183 billion in 1986 to $122 billion by 1990. Using Administration economic and technical assumptions, the decline in the deficit would be even greater--from $180 billion in 1986 to $82 billion in 1990.

TABLE 5. CBO AND ADMINISTRATION ESTIMATES OF THE ADMINISTRATION'S BUDGET PROGRAM (By fiscal year, in billions of dollars)

	1985	1986	1987	1988	1989	1990
Using CBO Technical and Economic Assumptions						
Revenues	735	789	855	934	1,007	1,090
Outlays	950	975	1,039	1,120	1,193	1,276
Deficit	215	186	185	186	187	187
Using CBO Technical Assumptions, Administration Interest Rates, and Other CBO Economic Assumptions						
Revenues	735	789	855	934	1,005	1,086
Outlays	950	972	1,034	1,102	1,152	1,208
Deficit	215	183	179	168	147	122
Using CBO Technical Assumptions and Administration Economic Assumptions						
Revenues	736	793	864	953	1,029	1,108
Outlays	950	972	1,033	1,100	1,148	1,202
Deficit	214	179	169	147	119	94
Using Administration Technical and Economic Assumptions						
Revenues	737	794	862	950	1,030	1,108
Outlays	959	974	1,027	1,095	1,137	1,190
Deficit	222	180	165	144	107	82

Figure 2.
Federal Deficit Projections



SOURCE: Congressional Budget Office.