United States General Accounting Office

GAO

Testimony

For Release
on Delivery
Expected at
2 p.m.
Friday
April 12, 1991

Budgeting for the Future

Statement of
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Before the
Subcommittee on Deficits, Debt Management,
and International Debt
Committee on Finance
United States Senate

Mr. Chairman and Members of the Subcommittee:

I am pleased to have this opportunity to appear before you today to discuss a subject that does not receive the attention it deserves--the effect of today's budget decisions on our future economic well-being and that of our descendents.

Our budget policies today are among the most important elements that will determine the national standard of living in the twenty-first century. Without sufficient investment in new factories, highways, research, education and all of the other factors that determine the productivity of our labor force, the United States will not be competitive in the future world economy. Unless we save today in order to provide for that investment, our children and grandchildren may find they cannot sustain a high standard of living while also supporting an increasingly large retired population. Without increased savings and investment, our standard of living may fall behind that of other industrial nations, and the United States may very well lose the preeminent position it holds today in the world economic order.

Unfortunately, our budget policies of the last decade have short-sightedly promoted consumption at the expense of our future economic well-being. Huge federal deficits have drained private savings that could have been devoted to new plants, equipment, and other productive private investments. At the same time, the budget has provided inadequate funding for highways, education, research and other public investments.

The Congressional Budget Office estimates that the total federal budget deficit will be a record $309 billion this year. As bad as that sounds, however, the situation is actually worse. Trust fund (Social Security, Medicare, federal retirement and others) surpluses totalling $120 billion partially mask a general fund deficit of over $400 billion. By the end of this fiscal year gross federal debt will probably grow to more than $3.6 trillion. This level of debt will require annual interest payments of almost $300 billion, about 19 percent of gross federal outlays. The Congressional Budget Office estimates that interest payments will exceed defense spending in fiscal year 1992, becoming the largest item in the federal budget.

The standing of the United States as a world superpower, as well as the future standard of living for us and our descendants, depends on our willingness to assume responsibility for the economic future by reversing our budget policies and providing for investment in that future.

NOT JUST A GOVERNMENT PROBLEM

It is important to point out that this kind of economic short-sightedness is not confined to the government. Our whole society seems beset by an increasingly short-run focus. Many observers decry the extent to which American business managers seem to be driven by short-run profits at the expense of the long-term health and growth of their companies. Businesses that emphasize a long-term view are sufficiently rare as to prompt major news stories in the financial press. Meanwhile, the personal savings rate has declined from an average of 8 percent of disposable income in the 1970s to just over 5 percent in the 1980s. There is even evidence that many citizens believe that personal saving is bad for the economy--that consumption is all that keeps unemployment down and incomes up.

I believe we all need to work to change these attitudes and to instill in our society a greater sense of responsibility to provide for a better future, but my testimony today is about what the federal government can do directly to improve the long-term economic outlook.

DEFICIT REDUCTION

The first, and most important, thing that the federal government should do is to take additional steps to reduce the federal budget deficit. A key issue here is the effects of our deficits on investment levels.

Our future economic well-being depends on investments in both physical and human capital that increase our ability to produce goods and services in the future. Funds for these investments come from national savings and capital from abroad. Since foreign investment leads to future flows of income from the United States to foreigners, our future standard of living will be enhanced to the extent we finance investment through our own national savings.

National savings is simply the sum of private savings and the total governmental (state and local governments as well as the federal government) deficit or surplus. Everything else being equal, an increase in the federal deficit reduces national savings. As you know, the federal deficit has increased dramatically in recent years, doubling every decade since 1950. In the 1950s the federal deficit averaged less than a half percent of GNP. In the 1980s it averaged more than 4 percent of GNP. The Congressional Budget Office estimates that the deficit will equal 5.5 percent of GNP this year.

But, in fact, everything else has not been equal. As I mentioned earlier, at the same time that the federal deficit has skyrocketed, the private saving rate has fallen significantly. The federal government should certainly consider whether there are steps that could be taken to increase the private saving rate. But the surest means of increasing national savings is to cut the federal deficit.

Last September GAO issued a report[1] that called for federal deficit reduction of approximately $1 trillion over the six years from fiscal year 1992 through 1997. Using then current budget projections we calculated that deficit reduction of that amount would produce a total budget surplus equal to about 2 percent of GNP by 1997. This would bring the general fund (excluding Social Security and other trust funds) close to balance and, if private savings rates remain constant, would restore the national savings rate to the pre-1980s post-World War II level needed to sustain long-term growth and ensure steady increases in our standard of living.

Last year's deficit reduction agreement was a step toward the goal, but fell somewhat short. The deficit reduction contained in the Omnibus Budget Reconciliation Act of 1990 and required under the Budget Enforcement Act of 1990 will total approximately $482 billion through fiscal year 1995, if fully implemented. However, the promised savings fall short of the deficit reduction called for in our report last September, and achieving even those promised savings is not certain. Funding for emergencies is excluded from the discretionary spending limits of the Budget Enforcement Act, and history indicates that we should expect at least some emergencies requiring additional

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[1] The Budget Deficit: Outlook, Implications, and Choices (GAO/OCG-90-5, September 12, 1990).

expenditures over the next four years. Any additional spending required to resolve savings and loan or bank failures would also erode the anticipated savings. In addition, $144 billion of the anticipated savings depends on legislation yet to be enacted--that is the appropriation bills for fiscal years 1992 through 1995. Achieving the required discretionary savings in the defense area could be especially difficult since the anticipated military force reduction has been at least delayed by the Persian Gulf War. Finally, the deterioration of the economy since last September makes it likely that even deficit reduction in the amount we called for would not produce a 2 percent surplus by the late 1990s.

Thus, while a good start was made last year toward eliminating the deficit drag on our economy, more deficit reduction needs to be achieved as soon as we have recovered from the recession.

ASSESSING LONG-TERM ECONOMIC EFFECTS

A second important step is for decision-makers to pay more attention to the long-term economic consequences of budget decisions. Some progress has been made in this regard recently, as seen from the debate over the need to ensure that the current Social Security surplus contributes to our ability to meet the high benefit payments that will be required as the baby boom generation retires. However, it is striking how little explicit consideration is given to economic goals and outcomes during most of the debate on the budget. Last year, when the Congress and the President were considering the deficit reduction package, the level of the deficit that would result from that package was discussed extensively (although most of the estimates were exceedingly optimistic), but the effects of the package on future economic growth or income were virtually ignored.

Many people talk at length about the importance of deficit reduction, but not enough has been done to demonstrate the actual economic effects of such reduction and to convince the American people that it is worth sacrificing now in order to bring the deficits down.

Those effects are demonstrated, however, in a recent study from the Federal Reserve Bank of New York[2]. That study provides quantitative estimates of the adverse effects of low savings in the 1980s, and the benefits that would derive from a restoration of the saving rate to the average level of 1950-1979. These estimates show 1989 GNP at least 5 percent lower than it would have been if savings had not fallen. By next year, the output loss may have grown to the point where we will not only be saving less, but also consuming less, than if we had maintained

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[2]Harris, Ethan S. and Charles Steindel. "The Decline in U.S. Saving and Its Implications for Economic Growth." FRBNY Quarterly Review, Winter 1991, pp. 1-19.

the higher saving rate. All the fun of the binge will be over, and there will be only the bills to pay. If the saving rate remains depressed, the annual GNP losses continue to increase into the early decades of the next century, when the retirement of the baby boom generation will put additional pressure on living standards.

The policy suggested in the New York bank's study--to achieve a unified budget surplus of about 2 percent of GNP late in this decade--closely conforms to our recommendation of last September. The study calculates that the first five years of this recovery policy add an average of a half percentage point to annual GNP growth, with larger gains thereafter. Higher savings will give us a brighter economic future, but the process takes time. It is not the path of instant gratification.

In addition to paying more attention to the kind of economic analysis in the New York bank's study, we also need to consider more systematically the long-term economic effects of a whole range of policies that are crucial to our ability to compete in the international market. Additional investments in plant and equipment will not keep the United States competitive if we continue to fall behind other nations in the quality of the education that we provide to our future work force. Drug use diverts resources from productive investments and makes workers less productive. Escalating health care costs soak up a greater percentage of national resources while many citizens continue to receive inadequate health care, making them less productive and likely to require more expensive care later. Inadequate investment in the transportation infrastructure threatens gridlock on the ground and in the skies, with resulting economic paralysis. Disarray in the banking system and capital markets threatens U.S. leadership in these areas.

In all of these areas, and in many others as well, it is important to look beyond the immediate federal budget costs of policies and consider their long-term consequences. I should add in this regard that the ideas of Herb Stein about "budgeting the GNP" through a multi-year plan[3] are interesting and worthy of consideration. As he points out, the government should also evaluate its tax, expenditure, and regulatory decisions in terms of their future effects on the allocation of the nation's total economic output, private and governmental, among such activities as national security, private investment, public investment, health care, consumption by the poor, etc. We must understand this total allocation, not simply the government's share, if we are to fully understand the impact of governmental decisions on current and future generations.

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[3]Stein, Herbert. Governing the $5 Trillion Economy. New York: Oxford University Press, 1989.

IMPROVED BUDGET PRACTICES

Of course, better analysis of the long-term effects of budget decisions is not enough. That information must be integrated into the budget decision-making and enforcement system in order to focus attention on those effects and to provide incentives to deal with them. This involves structuring the budget in an appropriate way, accurately accounting for long-term effects in the budget, and assuring the achievement of long-term goals on which agreement has been reached.

GAO has pointed out many areas where such improvements would be desirable. GAO's recommendations have already been at least partially adopted in a number of areas, such as the budgetary treatment of federal credit programs, accrual of military retirement benefits, and multi-year congressional budget resolutions and Budget Act enforcement.

One GAO proposal not yet adopted that would help illuminate the long-term economic effects of budget policies is the proposal for a six-part budget.

Six-part Budget

Although GAO strongly supports a unified budget, we believe that the present budget structure, with its exclusive focus on a bottom-line cash deficit, obscures important differences among programs, making it difficult for the public and many officials to understand what is actually going on in the government's finances. For example, looking only at a total budget deficit that nets out trust fund surpluses provides a misleading picture of the status of the government's financial affairs. In addition, large business-type operations such as the Postal Service are unable to plan and operate efficiently if they are subject to short-term spending controls more appropriate for programs financed from the general fund. Finally, critical capital investments for nuclear weapons plant modernization, bridge repair, and other purposes are postponed because the budget treats the purchase of long-term assets the same as the purchase of paper, pencils, and other consumables that are used up immediately.

GAO believes that the unified budget should be retained in order to reflect the government's total financial operations, but it should be divided into three major components--general, trust, and enterprise funds--with each component subdivided to distinguish between operating and capital expenditures. (See attachment showing the fiscal year 1992 budget displayed in the six-part format.)

The Congress has addressed certain aspects of the trust fund and enterprise fund issue by moving Social Security and the

Postal Service off budget. We do not believe that this is an appropriate solution to the problems because it creates confusion about the fiscal effect of total government operations and because it does not provide for consistent treatment of all trust funds and government public enterprise activities. In addition, history has shown that agencies that are moved off budget are moved back on at some point.

The earlier discussion of the need to increase national investment highlights the importance of dividing government spending between operating and capital expenditures. If we want to accurately measure the impact of the budget on national savings and investment, we should not assume, as does our current budget accounting, that all government expenditures represent consumption. We need to recognize that government expenditures for long-term assets do represent an investment in our economic future. We are aware that many people in the budget community fear that a separate capital budget within the unified budget could provide greater opportunities for gaming the budget process and avoiding controls on spending. We understand that some modification of our capital budget proposal may be necessary to allay these fears. We are eager to explore ways in which an appropriate treatment of capital expenditures can be achieved without jeopardizing appropriate controls on spending.

Other Possible Improvements

GAO has identified other areas in which improvements might be made: full accrual of liabilities for federal civilian employee retirement and other employment benefits and, possibly, accrual of liabilities for Social Security and other entitlement benefits; budget treatment of contingent liabilities such as deposit insurance; recognition of possible federal financial exposure in connection with Government-sponsored enterprises; and consideration of future costs resulting from federal government responsibilities in areas such as the clean-up of nuclear weapons facilities. We are continuing our work on these issues and will be happy to discuss our views on them today or in detail at some future date.

One other area of concern is our dependence on the baseline in analyzing whether our policies achieve the desired results in the outyears. The baseline is intended to show what the budget would be in the outyears if direct spending and tax policy do not change and discretionary spending is increased to keep up with inflation (or is at the levels set by statute, as in the case of the Budget Enforcement Act discretionary spending limits).

Something like the present baseline is probably an essential starting point for debating budget choices. Unfortunately, however, it can lull us into a sense of complacency. It is easy to think that we have the deficit problem well under control if the estimates of economic growth are high enough, or the estimates of the costs of programs such as Medicare are low enough. In addition to the problem that baseline estimates can be overly optimistic (and there are many who think that they generally are), the current baseline concept is not intended to capture spending increases resulting from the need eventually to clean up DOE's nuclear weapons facilities, rebuild America's infrastructure, fight an AIDs epidemic, or fight a Persian Gulf War. We all know that the government has unmet obligations and that we can expect bad things to happen occasionally, but the baseline simply does not reflect this knowledge.

When we use the baseline to judge our budget accomplishments, we should be aware of these shortcomings and adjust our evaluations accordingly. It would be wise for us to tend toward pessimism in our budgetary decision-making so that we will not continually come up short in our attempts to eliminate the federal deficit and increase our investment in the national economy.

In addition, the use of the baseline can sometimes cause confusion. For instance, the baseline level for Medicare is the level of spending estimated to occur if current law is not changed. If the law is changed so that estimated spending is less than that baseline level, this is considered as savings even though total Medicare costs may be higher than the year before. This allows decision-makers to separate out the effects of policy decisions from the effects of such factors as growth in the Medicare eligible population. It also recognizes the fact that restrictions on Medicare services certainly seem like cuts to beneficiaries even if total program costs go up. However, it is difficult to explain to decision-makers themselves, let alone the public, how we can cut Medicare year after year and yet Medicare costs are dramatically higher than they were a few years ago.

BUDGET STUDY COMMISSION

We recognize that these matters raise many policy and technical issues. Not all elected officials and budget experts would agree with our understanding of the problems and our prescribed solutions. Furthermore, there are other budgeting proposals that raise even more fundamental questions, such as proposals for line-item veto authority for the President.

Considering the importance of reaching consensus on how to improve our budgeting practices, I think that the Congress should consider establishing a high-level, bipartisan budget study commission similar to the 1967 President's Commission on Budget Concepts. I would probably wait a year or more before establishing such a commission, so as not to divert attention from the main task at hand--enforcing the current deficit reduction plan and enacting additional reductions. But the time will eventually come, I am sure, when such a body could make a major contribution. I also would think that one of the main objectives of such a commission would be an examination of how the federal government can better budget for the future.

CONCLUSION

We have made a start toward eliminating the deficit, but much remains to be done, both in dealing with the deficit itself and integrating the consideration of long-term economic effects into the budget process. Perhaps most importantly, we need to mount an all-out effort to convince both decision-makers and the American public that today's budget is a crucial factor in determining tomorrow's economic well-being. GAO will certainly continue its efforts in this regard.

This concludes my statement. I will be happy to answer any questions.

ATTACHMENT

PRESIDENT'S FY 1992 BUDGET RESTRUCTURED ACCORDING TO GAO PROPOSAL

(dollars in billions)

	Total	General	Trust	Enterprise
Operating surplus/deficit (-)	-250	-402	146	6
Capital financing requirements	-31	-33	8	-6
Unified budget financing requirements	-281	-435	154	1

Numbers may not add due to rounding