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United States General Accounting Office

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# Testimony

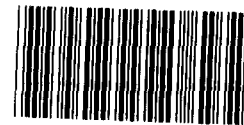
Before the Committee on Finance  
United States Senate

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## BUDGET POLICY

# Long-Term Implications of the Deficit

Statement of Charles A. Bowsher  
Comptroller General of the United States



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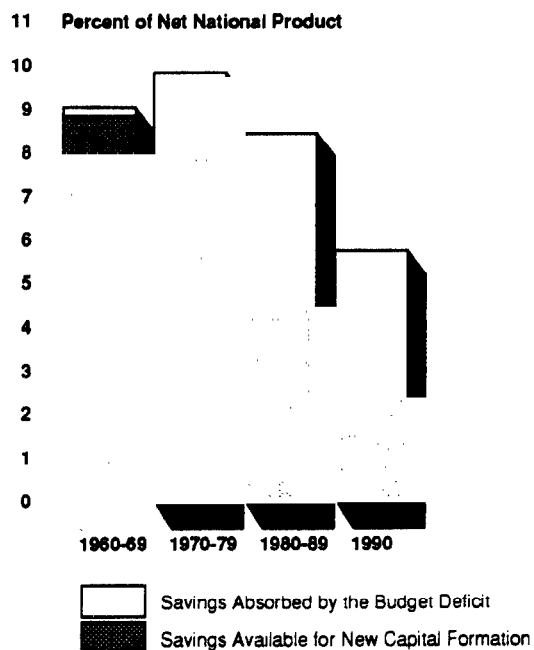
Mr. Chairman and Members of the Committee:

I appreciate the opportunity to appear today to discuss the importance of deficit reduction to our nation's long-term economic health.

The federal deficit is not the only problem we face as a nation, but if we cannot turn the deficit path around--if we cannot put ourselves on a credible path toward balance (or surplus)--then our ability to solve our other pressing problems will be severely limited.

Deficits by themselves do not create crises, but they do erode the savings needed for private investment and future economic growth. As figure 1 shows, the rising deficit in the 1980s and early 1990s coincided with a sharp drop in the net national savings available for investment. The share of national savings absorbed by the deficit grew from 2 percent in the 1960s to 58 percent in 1990. Only an influx of foreign capital sustained investment. Unfortunately this reliance on foreign investment has its price, because future profits and interest payments will flow abroad. There is much we do not yet know about increasing investment and productivity, but we do know that increasing national savings by reducing the deficit will promote greater investment and long-term economic growth.

**Figure 1: Effect of the Federal Budget Deficit on Net National Savings (1960-1990)**



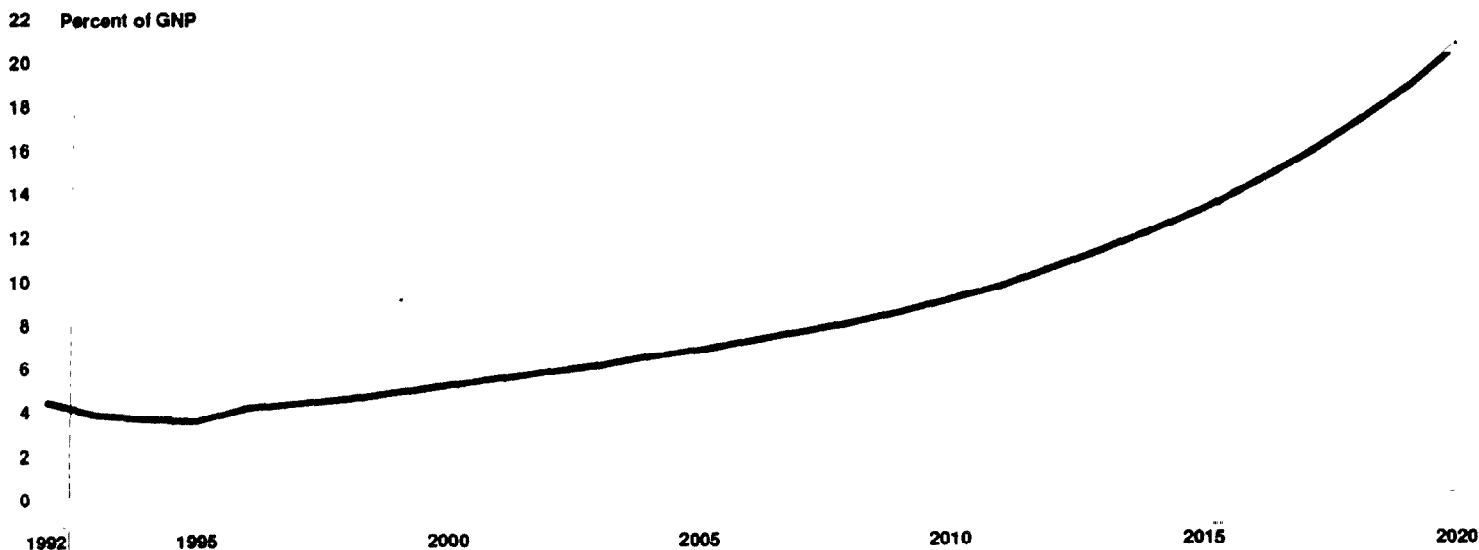
Source: Economic Report of the President, February 1992

Last June we issued a report<sup>1</sup> in which we sought to describe in concrete terms why we must act. In that report, we adapted a model developed by economists at the Federal Reserve Bank of New York to explore the long-term effects of different fiscal policies. In particular, the model captures the links between the deficit, interest costs, and the national savings rate. This year's deficit not only reduces this year's national savings, it also increases interest costs and deficits in future years, further depressing savings and economic growth.

### INACTION IS NOT A SUSTAINABLE POLICY

If we were to continue our recent spending and tax policies, our projections show deficits exploding to 20 percent of gross national product (GNP) by 2020. Figure 2 shows the deficit under this "no action" scenario. We do not believe this scenario can occur because we would face financial crisis before we reached that point, but the trends that produce the result are instructive. The steep increase in the projected deficit after 2010 reflects the symbiotic relationship of the growing debt and the increased interest costs associated with financing it, as well as rising retirement and health care costs. In our model this is happening in the environment of an economy whose growth is slowed by the debilitating effect of the deficits on national savings and investment. Indeed, in the final years of the projection period, the model shows the economy actually contracting.

Figure 2: No Action Scenario Budget Deficits (1992-2020)

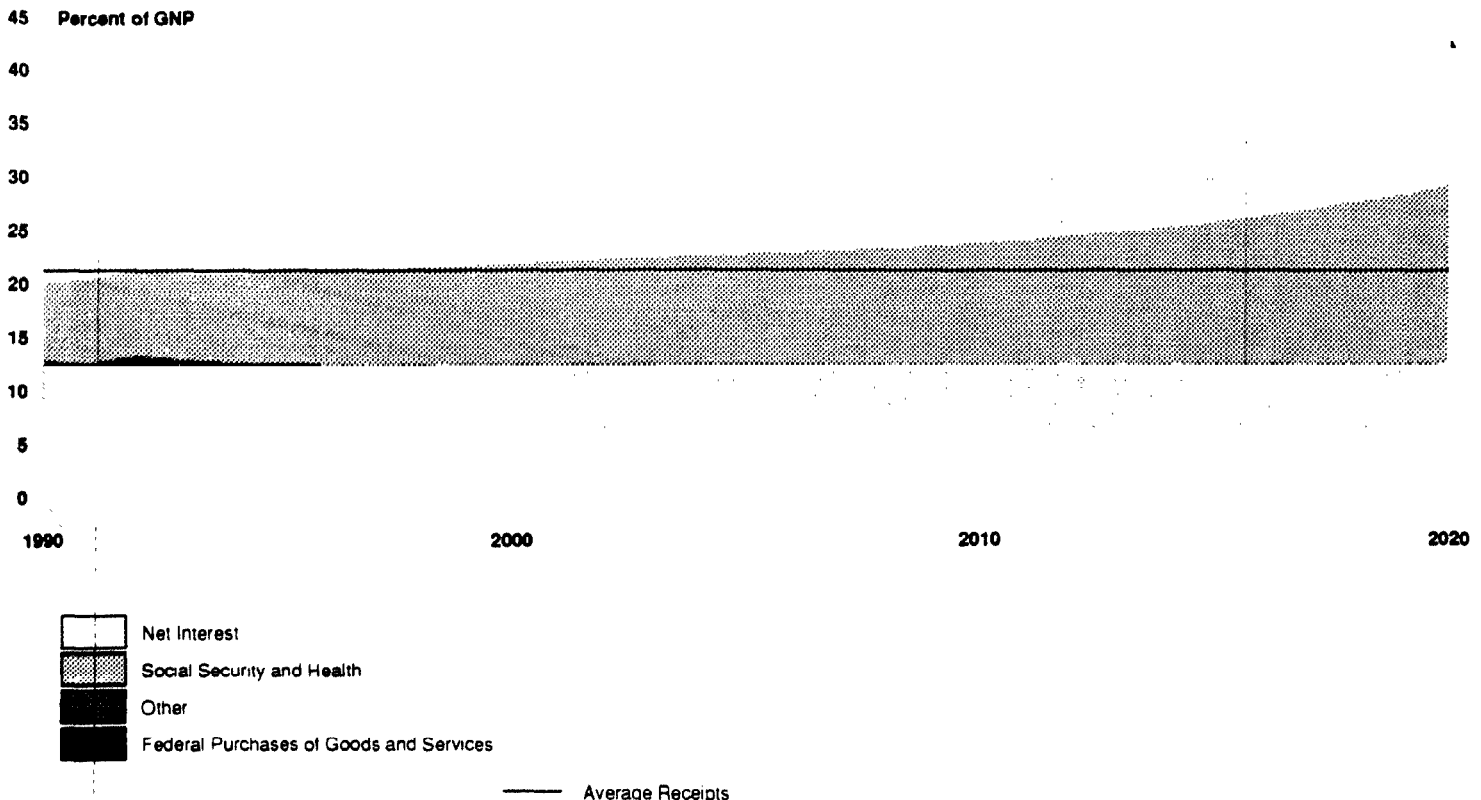


<sup>1</sup>Budget Policy: Prompt Action Necessary to Avert Long-Term Damage to the Economy (GAO/OCG-92-2, June 5, 1992).

Although these projections show what looks like an economic extreme, they are the logical extension of recent tax and spending policies. We do not believe this "no action" path is sustainable. If we do not act on our own initiative, a financial crisis would force us to act. Therefore, it is important to recognize that the question facing policymakers is not whether to reduce the deficit, but rather when and how to reduce it and whether we will design the program or have it forced upon us.

Figure 3 shows the forces driving the long-term explosion of federal spending if recent policies continue: health spending, interest payments, and retirement costs. Beginning around the year 2010, the nation will undergo a major demographic shift. The baby boom generation will enter retirement at a time of increased life expectancy. Not only will the number of elderly increase, but the number of the very old--who have disproportionately large needs for health and other services--will also increase. Moreover, in the year 2020, the ratio of workers to retirees will decline from today's 3.4-to-1 to 2.4-to-1.

Figure 3: Federal Expenditures in the No Action Scenario

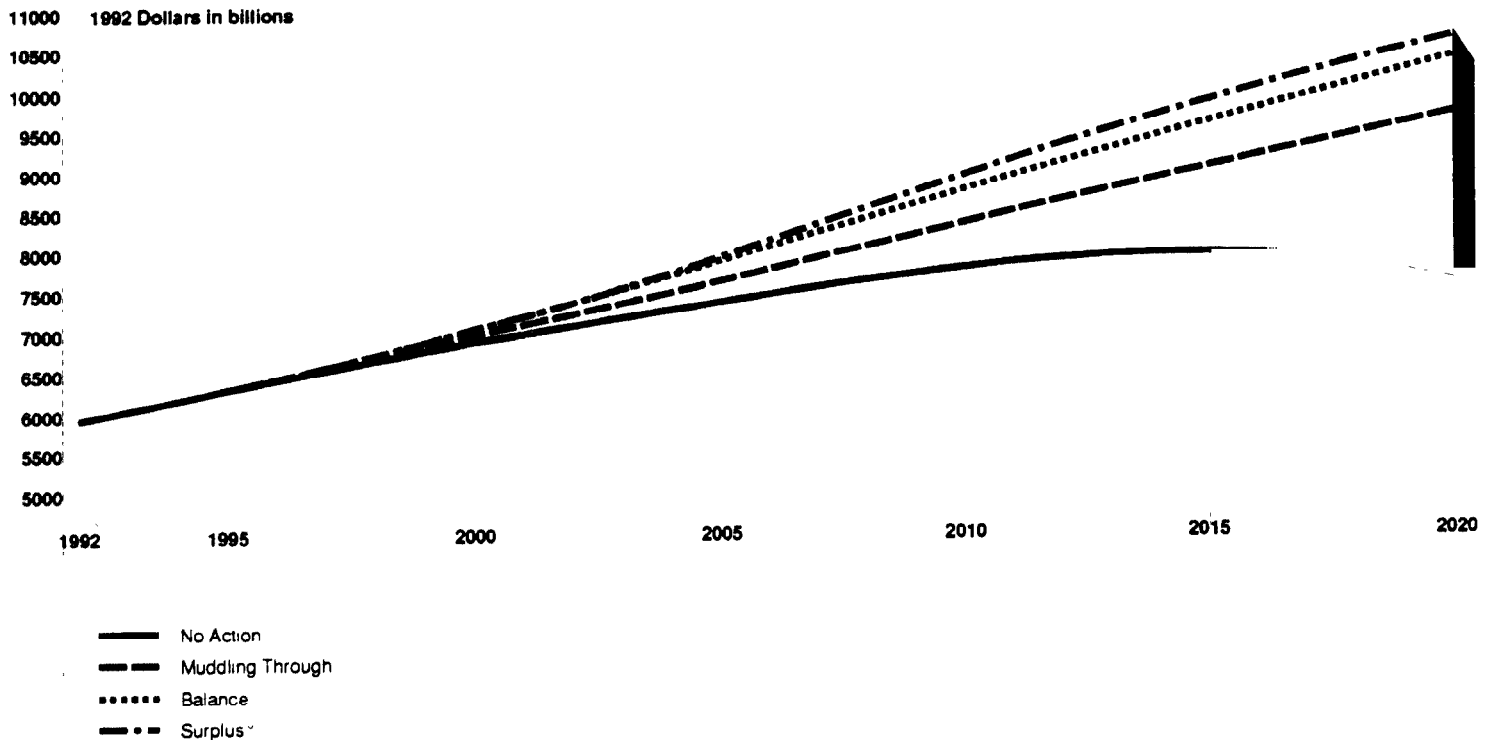


These demographic trends have profound implications for the budget. The size of the annual Social Security surpluses will begin declining around 2010, with outlays projected to exceed revenues by 2017 unless adjustment are made. The aging of the population will fuel the already-rapid growth in health care costs. Data from the Department of Health and Human Services indicate that Medicare and Medicaid outlays alone will grow from 2.8 percent of GNP in 1990 to about 7 percent in 2020. The burgeoning interest costs that inevitably accompany persistently high deficits will grow to consume over 30 percent of federal spending.

#### "MUDDLING THROUGH" STILL DOESN'T SOLVE THE PROBLEM

Recognizing that "no action" is unsustainable, we also looked at alternative deficit paths: (1) a "muddling through" scenario in which the deficit is held to 3 percent of GNP, (2) a balance scenario in which budget balance is achieved in 2001 and maintained, (3) a surplus scenario in which a 2 percent surplus is reached in 2005, maintained until 2010, and then phased down to balance by 2020. Our analysis showed that the timing of deficit reduction has a great impact on the magnitude of the sacrifice required as well as the economic benefits ultimately realized. Figure 4 shows the alternative GNP paths under our four scenarios.

Figure 4: Real GNP (1992-2020)

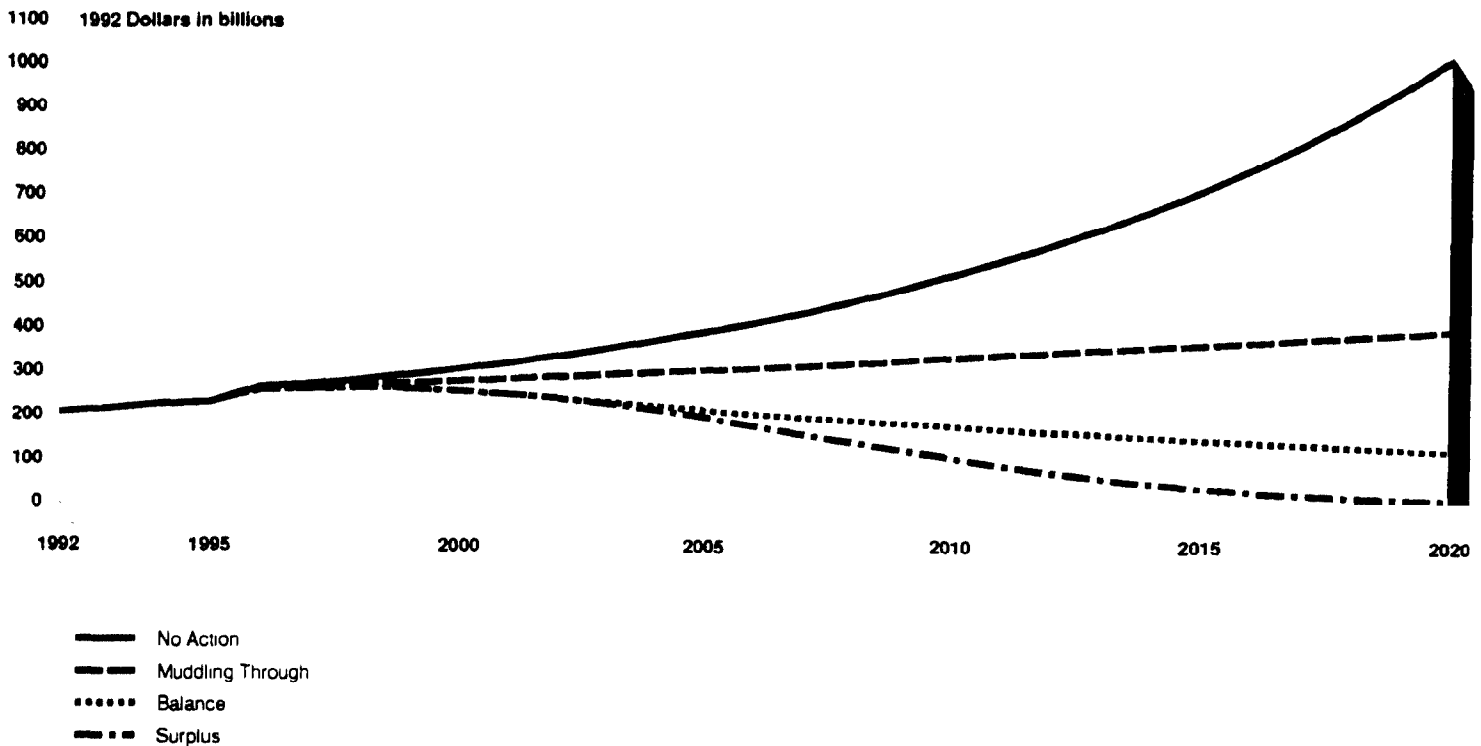


Choosing either the balance or the surplus policy path would represent a kind of preemptive strike against the otherwise inexorable spiral driven by health, interest payments, and retirement costs. While either of these choices would require sizable sacrifice and very difficult decisions in the near term, either would yield great long-range benefits to the health of the economy. Real GNP would grow significantly while both foreign debt and public debt would shrink. Major gains in economic output would be achieved while a greater share of domestic investment would be financed by domestic sources.

In contrast, while the "muddling through" option of bringing the deficit down to 3 percent of GNP and holding it there requires less sacrifice in the short term, it grows progressively more difficult--and it offers much less in terms of economic health. The "muddling through" option can be tempting; it could look like a kind of stable equilibrium after the substantial initial dose of deficit reduction required to get to 3 percent. Unfortunately, this is not the case. Maintaining a 3 percent deficit offers no escape either from progressively harder decisions or from an unacceptable economic future. It only postpones the date of a full confrontation with the underlying problem.

Moreover, failure to deal decisively with the deficit early on leads to a dramatic growth in interest costs--already the fastest growing component of federal spending. Compound interest is a wonderful thing when you are earning interest on savings. But, as you have so often pointed out, Mr. Chairman, compound interest is killing us in the budget. Over the last decade, we have seen how compound interest adds to the damage of a growing deficit as interest to finance the debt in turn adds to the amount of debt that must be financed. Under the "muddling through" option this phenomenon continues as interest costs reach nearly \$400 billion in 1992 dollars by 2020. Figure 5 shows net interest costs under the four scenarios.

Figure 5: Net Interest Costs (1992-2020)



#### WHAT IS THE OUTLOOK TODAY?

The projections I discussed above were released last June, based in part on Congressional Budget Office (CBO) near-term deficit projections as of January 1992. Depressing as these figures are, they now look to have been overly optimistic. Due in large part to the weakness of the economic recovery, the near-term deficit outlook is substantially worse than was predicted at the start of last year.

To provide some sense of how much worse, we reran the deficit scenarios with lower, now more realistic, inflation rates and compared the results to those of last spring. Current CBO baseline estimates are about \$40 billion higher than those we projected last spring. That is, we are starting even further down than we thought last year. (For more detail on what we did and the results, see attachment to this statement.)

Bad as these deficit numbers and the ones we usually cite are, in some ways they understate the problem. The 1992 unified deficit of \$290 billion was the result of a federal fund deficit of \$386 billion offset by trust fund surpluses of \$96 billion. Of that \$96 billion, \$51 billion was the social security trust fund surplus.



The role of interest payments in our budgetary woes is also highlighted by looking at the federal funds budget. The \$199 billion in net interest we paid in 1992 does not count the \$78 billion in interest paid to the trust funds--almost \$24 billion of which was paid to the social security trust fund.

Although the unified deficit is an accurate indicator of the impact of the federal budget on today's economy, it does not tell the whole story about the future. When we say the social security trust fund can cover promised benefits, we are assuming it continues to receive not only payroll tax payments but also interest on its balances. If we are concerned about providing for the baby boom's retirement without unduly burdening the next generation of workers, then we must be concerned about the trust funds. The trust fund surpluses will not help us deal with the future if they serve merely as an excuse to avoid making other deficit reductions. We should be seeking to reduce or eliminate the federal funds deficit.

In addition, most of the risks seem to be on the side of a worse-than-expected result rather than a better-than-expected outcome. By convention, budget projections ignore many future claims and the costs of unmet needs unless they are the subject of policy proposals in the budget. Examples of such claims and needs--some of which this administration did partially address--are: Pension Benefit Guaranty Corporation liability for underfunded pension plans; the cost of cleaning up and modernizing the Department of Energy's nuclear weapons production complex; the cost of hazardous waste pollution cleanup at military facilities; cost overruns in weapons systems, and modernization programs at the Internal Revenue Service, the Federal Aviation and Social Security Administrations, and the National Weather Service.

I list these not to create despair but to underline the need to act rapidly and decisively. There is much less risk of doing too much than of doing too little.

#### WHAT DOES THIS SAY ABOUT POLICY PROPOSALS?

The President's budget proposals and the House and Senate budget resolutions recognize the importance of bringing down the deficit. In addition, these proposals acknowledge that serious deficit reduction cannot be accomplished if any major spending category or revenue increases are left "off the table." Those involved deserve a great deal of credit for recognizing these facts.

The package of proposals now before the Congress represents an important first step although it will not, by itself, put us on a path to balance or surplus. Therefore, it is natural to question the wisdom of going ahead with the stimulus program. This is really a question of risks. The program is small enough that it

does not appear to raise the risk of reigniting inflation. And it does provide a modest amount of insurance in case the recovery proves to have weak legs. After all, economists have thought they smelled recovery before and been wrong.

There are always judgment calls in the design, size, and pace of economic programs. How fast should we bring down the deficit? How much deficit reduction should occur in the early years and how much later? Our judgment is the problem is less the current pace of deficit reduction and more its overall size.

Moreover, a huge piece of the deficit puzzle remains uncertain at this point. Controlling the rise of health care costs must be the second step in changing the direction of our deficit path. If health care reform is able to constrain the growth of health care costs--and the government's share of those costs--it could materially improve the outlook for the deficit. On the other hand, if expanded health insurance coverage were to be financed by the government without some way of offsetting the cost, the outlook for the deficit might worsen significantly.

Beyond health care there are further opportunities for serious re-examination of our goals and the effectiveness of programs designed to meet them. We will not be able to put ourselves on a path to balance or surplus simply by taking ever-larger cuts distributed across all programs. For example, how we restructure our defense effort will have budgetary implications far beyond any system-by-system reductions. I am hopeful that Vice President Gore's National Performance Review will help this process of reexamining basic assumptions and structures.

Finally, policymakers need to be prepared for contingencies. I spoke earlier about future liabilities and unmet needs. One of the lessons of the past is that budget outcomes are rarely better than expected. Moreover, putting off solutions usually just makes them more expensive. Aiming toward balance or surplus will give the budget a little more room to meet these claims and needs.

## CONCLUSION

Mr. Chairman, I hope these projections have helped to make the case for prompt and significant action to bring down the federal deficit. Deficit reduction is never painless. There is a supporter for every program and an opponent for every tax. Putting the budget on a path toward balance or surplus will require difficult decisions and some pain. But--and perhaps this is the most important part of my message--delay will eliminate neither the need to make hard decisions nor the pain they will inflict. Delay only guarantees that the decisions will be even harder and the pain even greater when policy correction is finally made. We do not have a choice whether to act; sooner or later action will be forced upon us. The question before us is when to act and how.

DESCRIPTION OF MODEL UPDATE

To provide a perspective on recent economic experience and on the administration's economic plan, we adjusted the four deficit scenarios in our report in one respect. We replaced the constant 4 percent per year inflation rate in the projections with lower, more realistic rates of increase of the implicit price deflator for Gross Domestic Product. For 1991 and 1992 we used the historical values, for 1993-1998 we used the forecast and projected values released by the CBO 2 months ago. This procedure gives us projected current dollar values for the four deficit paths out to 1998, figures that are comparable to the CBO's baseline figures and to the administration's estimates based on "CBO economics." Since the model we used for the projections is based on calendar year data from the national income and product accounts (NIPA), we used that basis consistently in the comparison.

This exercise gives rise to the following observations. First, for calendar 1992 the NIPA budget deficit turned out to be \$295.2 billion, as compared with a figure of \$258.8 billion in our projections made in June 1992. For 1993, the recent CBO figures suggest a calendar year baseline deficit of about \$273.5 billion; we had projected \$233.9 billion. Because the administration's economic proposals are oriented toward fiscal stimulus in the near term, their net effect on the NIPA deficit this year is to increase it by about \$9 billion.

Our four scenarios begin to diverge in 1994. In that year, the CBO baseline now indicates a calendar year NIPA deficit of about \$256.5. The administration's economic proposals would reduce that to \$223.5. Thereafter, the administration plan gradually reduces the deficit toward the value projected in our "muddling through" scenario. In calendar 1998, the administration plan would imply a deficit of about \$235.8 billion. Our 1998 "muddling through" value is \$230.4.

1. The first part of the document is a list of names and addresses of the members of the committee.

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