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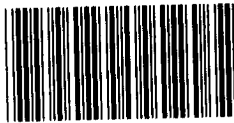
United States General Accounting Office

GAO

Transition Series

December 1992

Budget Issues



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GAO/OCG-93-1TR

United States
General Accounting Office
Washington, D.C. 20548

Comptroller General
of the United States

December 1992

The Speaker of the House of Representatives
The Majority Leader of the Senate

In response to your request, this transition series report discusses one of the most urgent issues facing the new President and the new Congress—the federal budget deficit. Since the issuance of our 1988 transition series report on the budget deficit, despite the passage of the Budget Enforcement Act, the budget deficit has grown. Unless we gain control of this deficit, we will find it increasingly more difficult to address pressing national needs or to increase long-term economic growth.

This report discusses the scope of the current deficit and describes the factors that must be dealt with to bring it down. Other reports in this transition series address specific program and management issues facing the government. All of the reports in this transition series are based primarily on detailed reports and testimony that GAO has provided to the Congress.

We are also sending copies of this report to the President-elect, the Republican leadership of the Congress, the appropriate congressional committees, and the designated heads of the appropriate agencies.

Charles A. Bowsher

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The Deficit—and Why It Is Bigger Than It Seems

The budget deficit remains among the most urgent issues facing the new President and the new Congress. This deficit has preoccupied Washington over the past decade, but concern about it has so far failed to galvanize the action needed to resolve it.

In 1988, we reported in our transition series that the unified budget deficit in that year was $155 billion, or 3.2 percent of Gross Domestic Product (GDP). Since then, it has grown to $290 billion in fiscal year 1992, or 4.9 percent of GDP.

The record $290 billion deficit in the unified budget measures the cash position of the government. Although it is a fairly accurate indicator of the macroeconomic impact of the deficit on the economy, it masks the composition of the deficit and understates the problem. A $96 billion surplus in the trust funds—including the Social Security trust funds—partially offsets a deficit of $386 billion in federal funds, leading to a unified budget deficit of $290 billion.

This trust fund surplus is a temporary phenomenon that will begin to evaporate within the next 20 years as the baby boom retires. The table below shows the relationship between the unified deficit, the

trust fund surpluses, and the federal funds deficit.

Table 1: Deficits

Dollars in billions

	1981 actual	1992 actual	1993 estimate[a]	1997 estimate[a]
Unified deficit	$79	$290	$331	$290
Trust fund surpluses	$7	$96	$108	$140
Federal funds deficit[b]	$86	$386	$439	$430

[a]Congressional Budget Office (CBO) estimates.

[b]Federal funds projections are not provided beyond fiscal year 1997.

In addition, the deficit in 1992 was held down by a delay in providing funds for Resolution Trust Corporation (RTC) activities. Since more funds will be needed to complete the cleanup of the savings and loan disaster, this decision merely shifted spending from fiscal year 1992 to fiscal year 1993 and beyond.

Finally, as we reported in 1988, an explosion of unfunded costs—many of which constitute future claims on federal budgetary resources—is looming. Some of these costs, including the following, are discussed in more detail in other reports in this transition series:

- The head of RTC estimates that an additional $25 billion will be needed for the savings and loan cleanup. Furthermore, several billion dollars will be needed to fund the new Savings Association Insurance Fund.

- The current administration has proposed a combination of management initiatives, base closings, and weapons terminations to bring Department of Defense (DOD) expenditures into line with the $1.4 trillion 1993-97 defense spending plan assumed in the budget. However, our work shows that many of the assumed savings may not materialize. DOD may be faced with additional program reductions of nearly $100 billion.

- In addition, the defense plans do not account for weapons systems cost growth. We estimate that these overruns will cost $35 billion between 1993 and 1997. (See National Security Issues, GAO/OCG-93-9TR, Dec. 1992.)

- DOD must clean up the hazardous waste pollution that has been identified at military facilities across the nation. DOD estimates the costs of cleaning up the sites identified to date at $24.5 billion. This figure is likely to increase. (See National Security Issues,

GAO/OCG-93-9TR, Dec. 1992.)

- The Department of Energy faces the task of cleaning up and modernizing its aging and environmentally hazardous nuclear weapons production complex. We estimate the long-term cost of cleanup and modernization to be at least $160 billion, up from our 1988 estimate of $100 billion to $130 billion. (See Energy Issues, GAO/OCG-93-13TR, Dec. 1992.)

- The Pension Benefit Guarantee Corporation has a current deficit of $2.3 billion, which could reach $17.9 billion by the year 2001. Seriously underfunded pension plans create a large contingent liability for the federal government. (See Labor Issues, GAO/OCG-93-19TR, Dec. 1992, and Pension Benefit Guaranty Corporation, GAO/HR-93-5, Dec. 1992.)

- The cost to renew the Department of Housing and Urban Development's current contracts providing rent subsidies to low-income families will jump from an estimated $7.5 billion in fiscal year 1993 to an estimated $17.1 billion in fiscal year 1997. (See Housing and Community Development Issues, GAO/OCG-93-22TR, Dec. 1992.)

- The cost of the Federal Aviation Administration's program to modernize the nation's air traffic control system has grown to $32 billion, an increase of about $7 billion from projections 4 years ago. Virtually all ongoing major projects are well over budget and years behind schedule. (See Transportation Issues, GAO/OCG-93-14TR, Dec. 1992.)

- The costs to modernize and update the Internal Revenue Service's (IRS) tax processing systems now are estimated to be about $23 billion through the year 2008. IRS needs experienced managers to direct modernization projects so that results can be delivered on schedule. (See Internal Revenue Service Issues, GAO/OCG-93-24TR, Dec. 1992.)

- The National Weather Service's modernization program has exceeded its expected cost and is far behind schedule. The initial cost estimate of $1.4 billion has risen to $4.6 billion, and the projected completion date has slipped from 1994 to 1999. (See Commerce Issues, GAO/OCG-93-12TR, Dec. 1992.)

- It could cost from $5 billion to $10 billion to modernize the Social Security Administration's computer systems over the

next 10 years. (See Health and Human Services Issues, GAO/OCG-93-20TR, Dec. 1992.)

In addition, public pressure is growing for government action on an agenda of national problems, including the following:

- The costs to modernize the public housing stock are estimated at over $20 billion. In addition, estimates of the costs to abate lead-based paint in public housing range from $6 billion to $16 billion. (See Housing and Community Development Issues, GAO/OCG-93-22TR, Dec. 1992.)
- The Department of Transportation estimates the cost of merely maintaining the condition of the nation's highways and bridges at 1989 levels over the next 6 years to be about $250 billion; improving their condition would increase costs to $425 billion. These estimates do not include funds for mass transit or rail systems. (See Transportation Issues, GAO/OCG-93-14TR, Dec. 1992.)
- Pressure has grown to extend health insurance to the 35 million uninsured. Cost estimates range from $12 billion to $30 billion per year. (See Health Care Reform, GAO/OCG-93-8TR, Dec. 1992.)

Why the Deficit Has Grown

The large deficit is a function of changes in both spending and revenue policies and of the recession. In the early 1980s, the combination of spending for an accelerated defense buildup and a simultaneous reduction in taxes established a large deficit. Cuts in domestic programs were too small to offset the net effect of increases for defense and cuts in taxes.

Once this large deficit was established, interest payments increased rapidly—growing from $69 billion in 1981 to $195 billion in 1991. At the same time, federal spending on Medicare and Medicaid grew by 180 percent, from $56 billion in 1981 to $157 billion in 1991. Concurrently, spending for deposit insurance and resolution of the savings and loan disaster exploded. In 1981, the deposit insurance system took in more than it spent, but in 1991, outlays for deposit insurance were $66.3 billion, or 5 percent of total outlays. Table 2 illustrates these trends.

Table 2: Outlays for Fiscal Years 1981, 1986, and 1991

Dollars in billions

	1981 Actual outlays[a]	1986 Actual outlays[a]	1991 Actual outlays[a]	Percent change 1981-91
Defense	$158	$273	$273	74
Net interest	69	136	195	183
Health				
Medicare	39	70	104	167
Medicaid	17	25	53	212
Medicare and Medicaid	56	95	157	180
Deposit insurance[b]	−1	1	66	
All other	397	485	632	59
Total[c]	**$678**	**$990**	**$1,323**	**95**

[a]Amounts in nominal dollars.

[b]Calculated on a cash basis.

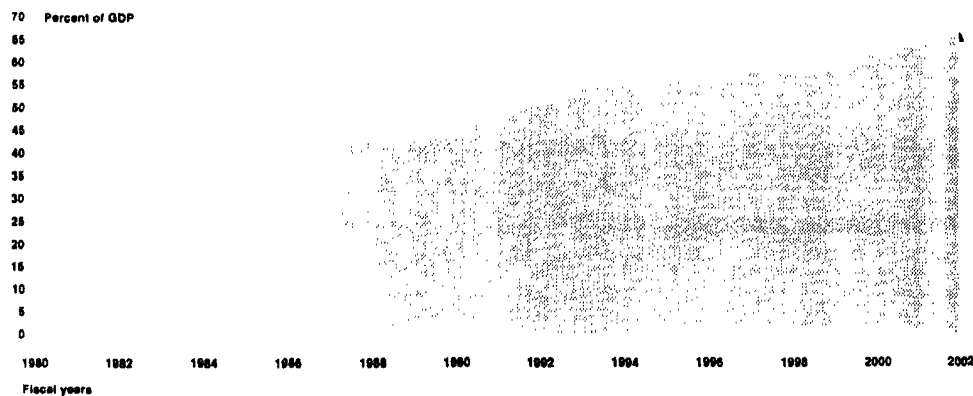
[c]May not add because of rounding.

During this period, additional cuts in domestic programs and increases in taxes—combined in the second half of the decade with a slowdown in defense spending—were insufficient to eliminate the deficit built into the structure of the budget. Between 1981 and 1991, federal spending as a whole increased to 24 percent of GDP while revenues generally remained at about 19 percent of GDP. Indexing on the revenue side helped to hold revenues nearly flat and removed another source of fiscal slack. In

addition, tax expenditures have grown rapidly in the last few years, despite the 1986 tax reform, thereby further eroding the revenue base.

The federal debt grew rapidly with rising deficits. In 1981, debt held by the public was $784.7 billion. In 1992, it was about $3 trillion. CBO projects it to reach $6.5 trillion in 2002. The interest payments on this debt have absorbed an increasing share of federal outlays, from 10 percent in 1981 to 15 percent in 1991. Furthermore, the debt has increased relative to GDP, growing from 26 percent in 1981 to 50 percent in 1992, as figure 1 shows.

Figure 1: Debt Held by the Public (1980-2002)



Source: Budget of the U.S. Government and CBO projections.

Future Deficit Trends Not Promising

The deficit will not resolve itself without major changes in the federal policies responsible for the trends. Although improvements in the economy could help reduce the deficit in the short term, a large structural deficit would remain. Chronic deficits are embedded in federal fiscal policy, and forecasts indicate that, absent further policy changes, the deficit will only become worse over time.

Since we issued our 1988 transition series report, the 1990 Budget Enforcement Act (BEA) established a renewed framework to control spending. It succeeded in controlling the growth of discretionary spending provided through the appropriations process, and it prevented the expansion of entitlements or tax expenditures. It did nothing, however, to control growth in the cost of existing entitlements or existing tax expenditures.

Although BEA succeeded in trimming $500 billion over 5 years, the deficit nonetheless grew to record levels, thanks to a worsening economy, rapid growth in health care costs, increasing interest payments, and the continued cost of resolving the savings and loan crisis.

Current projections suggest that unless current policies are changed, high deficits will persist even as the economy improves. CBO projects that under current policy the deficit in 2002 will reach $514 billion, or 5.2 percent of GDP. Spending for health care and net interest continues to drive the deficit. However, deposit insurance should cease being a major contributor to the deficit as the industry's problems are resolved.

Without action, the problem will only worsen over the longer term. In a previous report, we adapted a long-term economic growth model developed at the New York Federal Reserve Bank to estimate the potential results in 2020 of alternative deficit reduction paths. If current policies remain unchanged, deficits could explode to over 20 percent of Gross National Product (GNP) by 2020. In this no-action scenario, health care costs, retirement costs, and ballooning interest costs combine to create a dramatic rise in spending; higher deficits and lower savings slow the growth of real GNP. Our economy could not possibly sustain deficits of this magnitude. Although this scenario is implausible, the trends demonstrate that the choice facing the nation is not whether to reduce the deficit but how and when.[1]

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

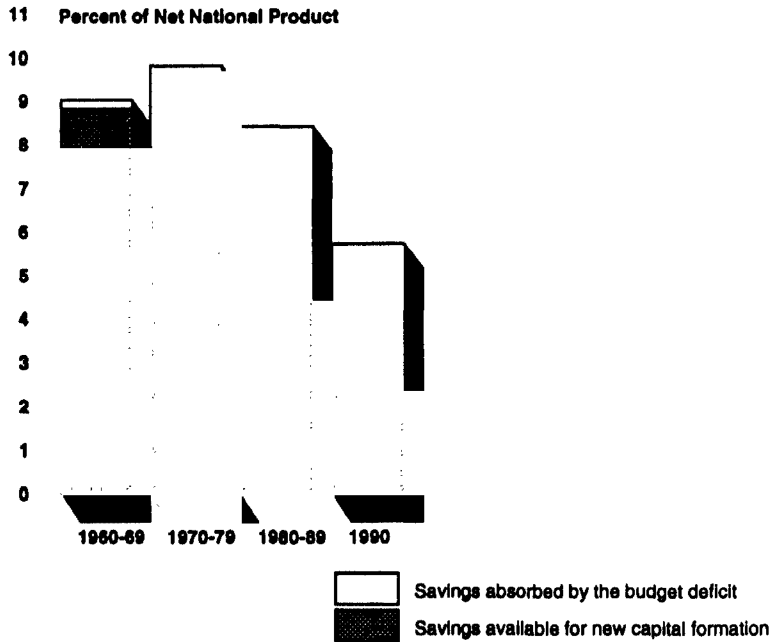
Why the Deficit Matters

Large and persistent federal deficits matter for three reasons. They constrain the ability of government to address the pressing national needs discussed above. Some economists say they also limit the ability of the government to respond to economic downturns through fiscal stimulus because such action might prompt offsetting increases in interest rates driven by markets already nervous about the impact of growing deficits.

In addition, the deficit matters because it absorbs savings that would otherwise be available to finance investment, and investment is critical to long-term economic growth.[2] During the 1960s, the budget deficit absorbed approximately 2 percent of net national savings. Today, federal borrowing absorbs over 50 percent of a diminished pool of national savings potentially available for economic investment. (See fig. 2.)

[2]See Investment (GAO/OCG-93-2TR, Dec. 1992) and Budget Policy: Prompt Action Necessary to Avert Long-Term Damage to the Economy (GAO/OCG-92-2, June 1992).

Figure 2: Effect of the Budget Deficit on Net National Savings (1960-90)



Source: Economic Report of the President (Feb. 1992).

During the 1980s, investment levels were lower than in the previous two decades. Inflows of foreign capital kept investment higher than our savings would otherwise have permitted. However, this foreign investment has some cost—the United States

must ultimately pay dividends or interest to the foreign owners of the assets involved.

We may already be paying a price for the decline in national savings and investment. Low savings rates have increased real interest rates and thus reduced investment needed to raise productivity and economic output.

What Must Be Done

The nation needs to set a long-term fiscal policy path. The federal government should assume responsibility for increasing the level of national savings and investment enough to brighten the long-term prospects for healthy economic growth. This suggests the establishment of a set of long-term fiscal goals, perhaps stretching over a 30-year period, to promote accountability for the long-term economic consequences of today's decisions.

The agenda is daunting but not impossible. Successful examples of such actions include the creation of the interstate highway system, the enactment of credit reform that recognizes the long-term cost implications of current actions, and the enactment in 1983 of Social Security reforms that phased in changes over time.

If short-term stimulus is needed to jump-start the economy, it should be part of a long-run, credible plan for deficit reduction.[3] Such a package would help assuage the financial markets and could forestall a self-defeating rise in long-term rates that could choke off the desired

[3]See Investment (GAO/OCG-93-2TR, Dec. 1992) for a discussion of the differences between short-term stimulus and programs designed to promote longer-term investment in infrastructure, human capital, and research and development.

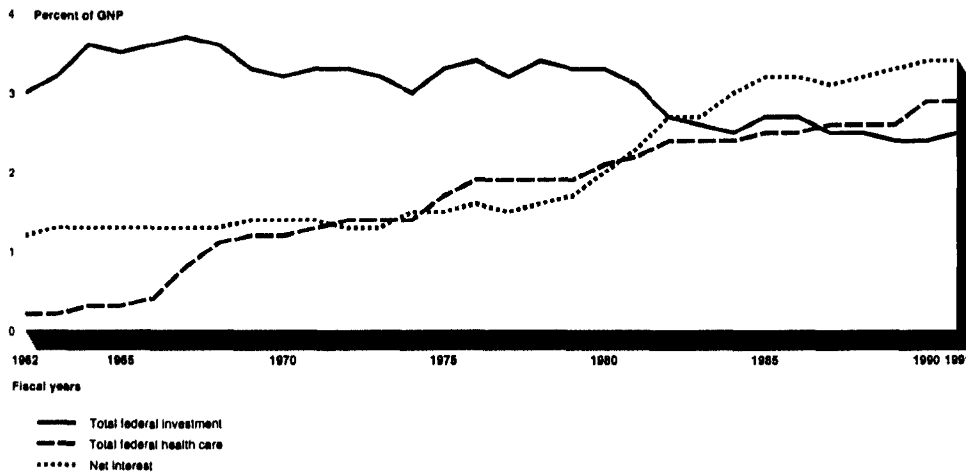
recovery. To ensure that measures introduced as temporary do not worsen the long-term deficit problem, programs intended to provide short-term stimulus should be phased out or paid for—either with cuts in other programs or new revenues—as the economy improves.

Early action on the deficit is important for several reasons. First, it will slow the growth in federal interest costs—and interest is the ultimate example of an expenditure that does not provide any current public service. Second, early action would take advantage of defense reductions arising from the changing U.S. position in the post-Cold War world. Third, demographics favor early action. Reforms in health care and retirement programs can be introduced and phased in before a shift in the worker-to-retiree ratio dramatically escalates both program costs and political obstacles.

Over the last decade, discretionary spending has fallen as a share of the budget from 45 percent in 1981 to 40 percent in 1991. One of the consequences of that decline has been a reduction in funding for federal programs with a potential long-term impact on

economic investment.[4] (See fig. 3.) The budget and accounting process does not recognize the long-term economic benefits of these programs, and funding for them has declined as a percent of GDP since 1980, from 3.3 percent to 2.5 percent in 1991.

Figure 3: Outlays for Federal Investment, Health, and Net Interest (1962-91)



Source: Budget of the U.S. Government.

Federal programs promoting long-term investment should be highlighted, even as

[4]See Investment (GAO/OCG-93-2TR, Dec. 1992).

deficit reduction occurs. A shift in the composition of federal spending to investment could be supported, particularly if well-designed investment programs can be developed that promise significant returns for economic growth.

The nation's fiscal policy stance should be determined on macroeconomic grounds. The choice between spending for consumption and investment is a trade-off that should occur within the overall budgetary constraints of the previously selected fiscal policy path. While public investment programs can help promote economic growth, the large deficit remains as a critical impediment to private investment and long-term economic growth.

Better budgetary decisions could be facilitated by restructuring the way the budget is presented. For the investment debate, a restructured budget could highlight the investment portion of the budget. A restructured budget could also illuminate other structural aspects or trends in the budget, such as the role of trust fund surpluses in masking the federal funds deficit.

Strategies for Reducing the Deficit Will Have to Involve All Major Portions of the Budget

The conclusion that we reached in our 1988 transition series report remains valid today—there are no quick or painless solutions to the deficit. It will be difficult, if not impossible, to achieve either balance or a surplus early in the next century if any major areas of spending or potential revenues are set "off the table." The very magnitude of the changes needed is likely to prompt a major debate over the role of the federal government and how to pay for it. It is also possible that the search for budgetary savings could prompt a reexamination of ways to achieve federal program goals at less cost.

To achieve the necessary deficit reduction, decisionmakers will need to look at large and/or growing areas of the budget—mandatory spending, defense, domestic discretionary spending, and revenues.

Controlling Mandatory Spending Means Containing Health Care Costs

Controlling the growth of mandatory spending is critical to regaining control over priorities in the budget and obtaining the flexibility needed to introduce new programs in response to changing needs. Most programs in this category are growing at a moderate rate. Within this category, health

care costs both are now and will be the most rapidly growing segment. Social Security costs will not become a major problem until the second decade of the 21st century, when the Social Security surplus will disappear and outlays begin to exceed revenues.

Major health care reform is a necessary part of any effort to control the budget. Such reform would have to achieve major changes in the structure and incentives provided by our health care financing system to attain effective cost control. Across-the-board budget caps on federal health care spending, or on all mandatory programs, have been suggested as a way of controlling these costs. To be meaningful, however, such caps must be accompanied by the definitive changes in program structure and design that will be required to conform to the caps. Not making these fundamental choices simply postpones the hard choices and raises doubts about the enforceability of the caps.

As is the case for overall fiscal policy, a long-term plan is important in recapturing control over programs that seem to be out of control in the short run. Furthermore, long-range plans can help obtain consensus for major policy changes by giving affected

beneficiaries and providers enough time to adapt. Such a strategy was used with considerable success in the 1983 Social Security reform to phase in potentially disruptive increases in the age that participants become eligible for benefits.

Discretionary Spending: Reexamining Roles

Although defense spending has declined, it might become a candidate for further reduction as the nation continues to redefine its role in the post-Cold War world. Continued attention will be given to reducing U. S. overseas commitments, perhaps with a concurrent increase in the share of the defense burden borne by others. In 1991, the United States spent about 5.5 percent of its GDP on defense, compared with about 3.0 percent for other NATO nations and 1.0 percent for Japan.

Domestic discretionary programs bore the brunt of the budget cuts in the 1980s. This does not mean that these programs should now be exempt from examination. Some could be better designed or made more efficient to reduce program costs. Alternative sources of support, such as user fees and increased cost sharing, might be

considered for some programs.[5] In other cases, less costly means could be considered to achieve federal goals; for example, alternatives to traditional imprisonment—such as halfway houses, electronic home detention and "boot camps"—could help reduce the escalating costs of constructing and operating federal prisons.[6]

However, it seems likely that, within the discretionary category, the question may be less reducing the total than changing the mix of spending, by, for example, shifting toward programs that support long-term economic growth and away from those that finance current consumption. Although such a shift might not reduce the deficit, it would represent a healthy adaptation of the budget to changing social needs.

Further major cuts in domestic discretionary spending would necessitate a wide-ranging reassessment of the federal role in such areas as education, transportation, and housing. The federal role was originally premised on the inability or unwillingness of states and localities to provide sufficient services in these areas. Dramatic changes in state and local managerial and programmatic

[5]For a discussion of potential changes in the financing of federal natural resource programs, see Natural Resources Management Issues (GAO/OCG-93-17TR, Dec. 1992).

[6]See Justice Issues (GAO/OCG-93-23TR, Dec. 1992).

profiles, due in part to the presence of many federal grant programs, may argue for a change in the federal role.

Revenues Are Likely to Be Part of the Package

It is likely that spending cuts alone will not suffice to eliminate the deficit. The size of the deficit and our recent budgetary history suggest that revenue increases are likely to be part of any credible strategy to substantially reduce the deficit. Proposals to raise taxes provoke controversy because tax increases take resources out of the economy. However, borrowing also takes resources from the economy, albeit in a less visible and less direct way.

Revenues are likely to be part of any package because a major factor driving up the deficit has been that growth in revenues has not kept pace with federal spending. Spending rose to nearly 24 percent of GDP while revenues remained at 19 percent. These figures alone, however, do not tell the whole story. The mix of revenues has also changed. Taxes supporting government operations other than social security dropped from 15.3 percent of GDP in 1980 to 13.5 percent in 1991 while social security taxes rose from 4 percent to 5.2 percent of GDP.

If revenue increases are to be a part of the deficit reduction equation, several major revenue-raising options are available. The choice among them involves not only the amount of revenue that each raises but also differences in their impacts on economic choices, on who bears the burden, and on tax administration. Major revenue options include income tax rate increases, base broadening through reductions in tax expenditures, gasoline or general energy taxes and environmental taxes, and/or a value-added or consumed income tax.

Tax rate increases can raise significant revenues with little administrative difficulty. However, it could be argued that, although technically simple, raising rates beyond a certain level could unravel the consensus behind the 1986 tax reform, which broadened the income tax base in exchange for reduced rates.

Tax expenditures have continued to grow, resulting in $374 billion in lost revenues in 1992. Reviewing these "programs" could both reduce revenue losses and prompt a much needed examination of the programmatic goals and impacts of these provisions. Our previous studies have questioned the efficiency of many of these

provisions, finding that many subsidize activities that would be undertaken anyway. Further, the concept of shared sacrifice could prompt efforts to scrutinize this sector of the federal budget at a time when outlay programs benefiting other groups are being examined and perhaps reduced.

A gasoline tax and other energy and environmental taxes could provide both revenue and financial incentives promoting national goals in these areas.

Concern about low savings in the United States periodically gives rise to interest in value-added or consumed income taxes. Most recently, the Strengthening of America Commission recommended replacement of the income tax with a consumed income tax as a way of both providing savings incentives and reducing the deficit.

Conclusion

Current budget deficits hamper the government's ability to respond to economic downturns and pressing national needs and also absorb savings that would otherwise be available for investment to help increase long-term economic growth.

Action is necessary on two fronts. The deficit must be brought down. The composition of federal spending must be shifted to put a greater emphasis on investment than on consumption.

Reversing these patterns will require difficult decisions affecting spending and taxes. The benefits of doing so, however, are great. A credible program to put the long-term deficit on a downward path will help ensure a rising standard of living for ourselves and for succeeding generations.

Related GAO Products

Budget Policy: Budgetary Treatment of Investment Programs (GAO/T-AFMD-92-15, July 23, 1992).

Budget Policy: Long-Term Implications of the Deficit (GAO/T-OCG-92-4, June 5, 1992).

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

The Effects of Budget Enforcement Act Discretionary Spending Limits in Fiscal Years 1994 and 1995 (GAO/T-AFMD-91-8, July 16, 1991).

U.S. Health Care Spending: Trends, Contributing Factors, and Proposals for Reform (GAO/HRD-91-102, June 10, 1991).

Budgeting for the Future (GAO/T-AFMD-91-1, Apr. 12, 1991).

The Budget Deficit: Outlook, Implications, and Choices (GAO/OCG-90-5, Sept. 1990).

Budget Deficit: Appendixes on Outlook, Implications, and Choices (GAO/OCG-90-5A, Sept. 1990).

The Question of Rolling Back the Payroll Tax: Unmasking the Deficit Illusion (GAO/T-HRD-90-10, Feb. 5, 1990).

The Budget Treatment of Trust Funds (GAO/T-AFMD-90-1, Oct. 12, 1989).

Managing the Cost of Government: Proposals for Reforming Federal Budgeting Practices (GAO/AFMD-90-1, Oct. 1989).

Value-Added Tax Issues for U.S. Tax Policymakers (GAO/GGD-89-125BR, Sept. 15, 1989).

The Budget Deficit (GAO/OCG-89-1TR, Nov. 1988).

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Foreign Economic Assistance Issues
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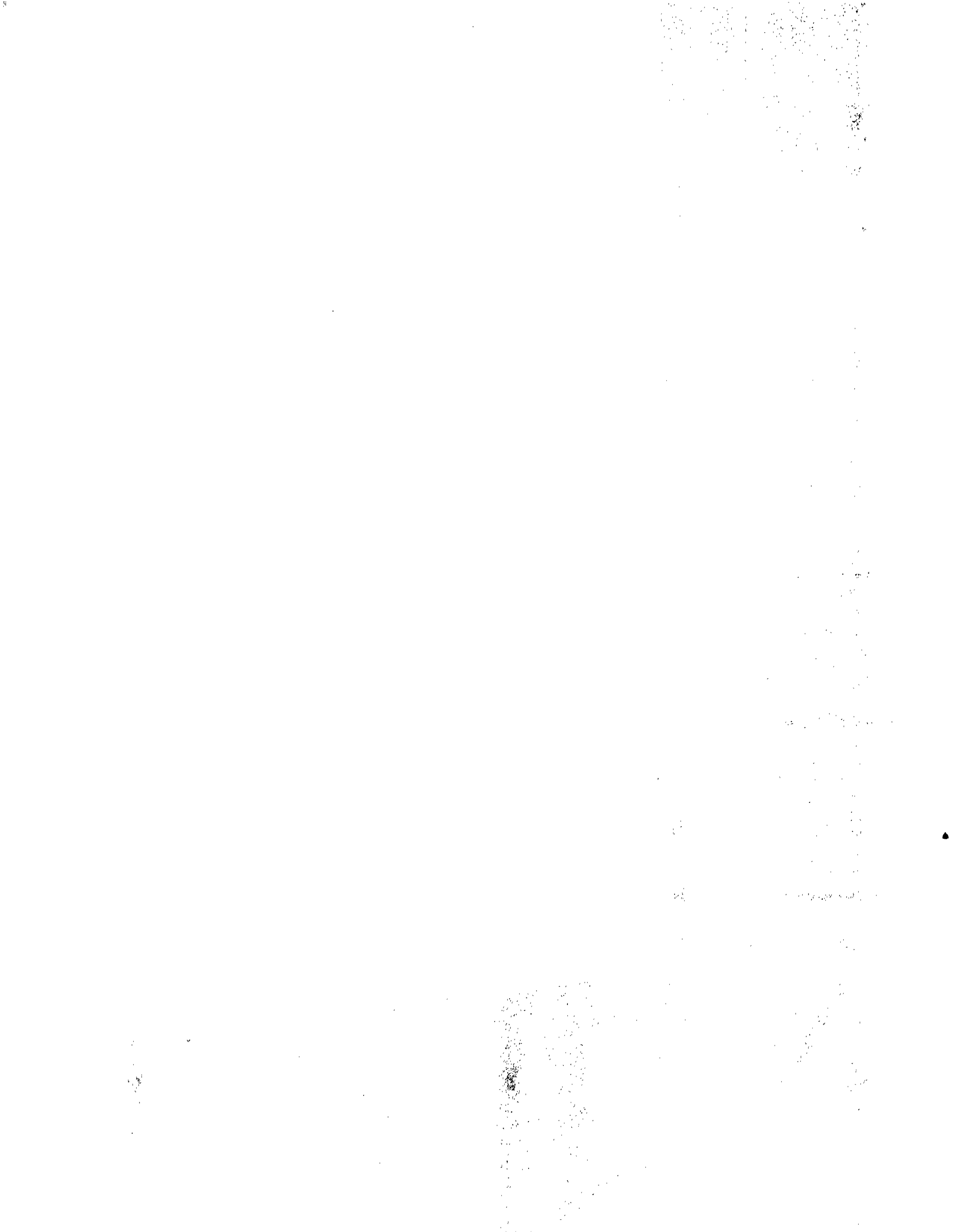

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