United States General Accounting Office

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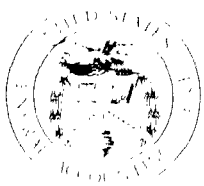
Report to Congressional Requesters

September 1990

THE BUDGET DEFICIT

Outlook, Implications, and Choices



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

Comptroller General
of the United States

B-240983

September 12, 1990

The Honorable Charles E. Grassley
United States Senate

The Honorable J. James Exon
United States Senate

The Honorable Daniel P. Moynihan
United States Senate

The Honorable Bill Bradley
United States Senate

This report responds to your joint request that we provide our views on the dimensions of the budget problem facing the nation, the implications of the deficit for the U.S. economy, and some of the choices that must be made to attack the deficit problem.

The deficit has doubled as a percent of gross national product (GNP) every decade since the 1950s. This ominous trend has reflected a growing imbalance between revenues and outlays in the general fund portion of the budget. The resulting deficits seriously depleted the nation's supply of savings in the 1980s, which adversely affected our investment and long-term growth. Rising deficits and borrowing have also meant that increasingly larger portions of federal revenue are being used for debt service rather than for other more productive purposes. We are recommending that this trend be reversed by a $300 billion fiscal policy swing that would result in total budget surpluses of approximately 2 percent of GNP annually by 1997—and close to a balance in the general fund.

We do not recommend specific program choices for reaching the fiscal policy goal, but provide the Congress and the executive branch with scenarios and packages covering defense and nondefense spending, as well as revenues, for achieving such a fiscal target. We also discuss alternatives for enforcing budget agreements, basic budget reform initiatives, and improved federal government stewardship over its resources.

Charles A. Bowsher
Comptroller General
of the United States

Executive Summary

This examination of the deficit was requested by Senators Exon and Grassley, subsequently joined by Senators Moynihan and Bradley.

The deficit is a serious problem with ominous implications for the long-term health of the economy. It is particularly disturbing to note that each decade since World War II has witnessed a further deterioration of fiscal policy. But only since 1981 have deficits been high enough to increase dramatically the size of the debt relative to the economy. This explosion of deficit spending has been accompanied by a decline in the U.S. saving rate. Together they bode ill for future investment and economic growth, and thus for the future standard of living of the American people.

There are many ways of reversing these trends. However, all involve specific policy changes that are politically difficult, and the large number of alternatives can lead to endless debate. The options examined in this report are intended to provide a basis for constructive dialogue leading to an agreement between the executive and legislative branches on a long-term structural solution to the deficit problem. An agreed-upon multiyear budget plan is the key to future fiscal responsibility.

The views expressed in this report are based on our many years of analyzing government programs, on our experience with financial management, and on our involvement with the budget process since the enactment of the Congressional Budget Act and the Gramm-Rudman-Hollings legislation.

Nature of the Problem

Deficit

Federal budget deficits are not new. By any measure, however, they are getting worse. As figure 1 illustrates, the average deficit as a percent of the gross national product (GNP) has doubled every 10 years for the past 40 years. Moreover, although the Gramm-Rudman-Hollings law required steadily decreasing deficits, at present the deficit is out of control. In January 1990, the Office of Management and Budget reported a baseline deficit for fiscal year 1991 of $100.5 billion. As figure 2 shows, only a few months later—partly reflecting rising costs of the Resolution Trust Corporation—that office and the Congressional Budget Office posted the current figure of over $230 billion—an estimate that is still rising. Even this figure masks the true size of the general fund deficit because

it includes large surpluses in Social Security and other retirement trust funds. Excluding them, the current 1991 estimate is $372 billion. A recession could push it beyond $400 billion.

Figure 1: Average Deficit by Decade
(1950-1989)

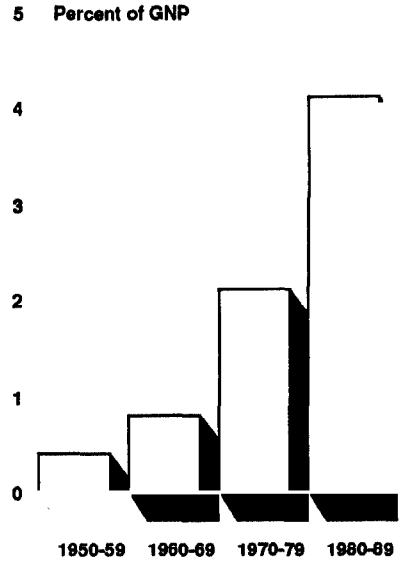
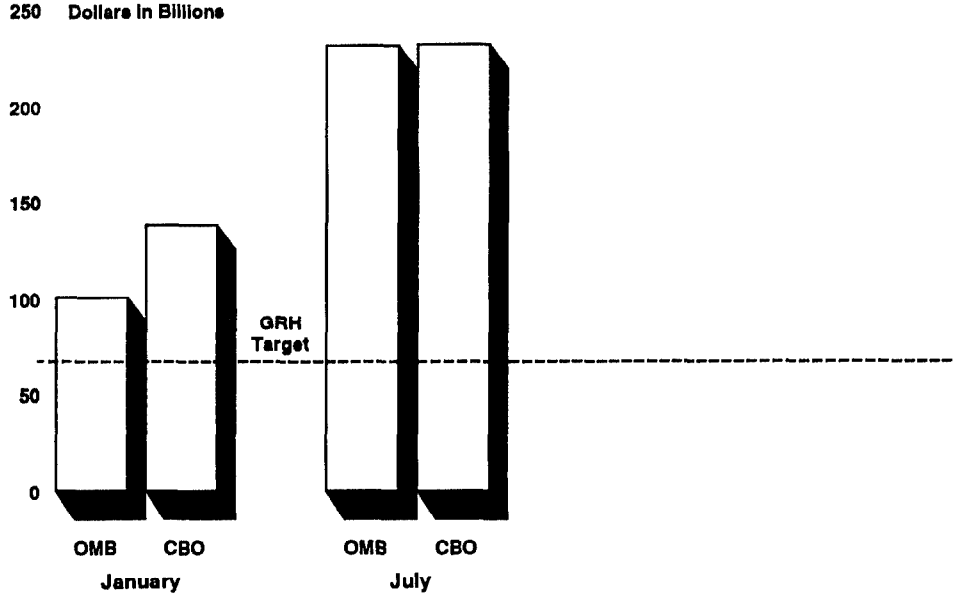


Figure 2: Changing Estimates for 1991 Total Deficit



Debt

Deficits have to be financed, so they add to the debt. For the first 35 years after World War II, however, debt held by the public did not grow as fast as the economy. As a result, debt as a percent of GNP declined steadily until 1974. The ever-larger deficits of the 1980s reversed this trend; currently debt as a percent of GNP is back to its 1963 level, as shown in figure 3. More than $1.6 trillion has been added to the debt held by the public since 1980. But the total federal debt, including the amount held by Social Security and other trust funds, has increased even more, by $2.3 trillion. As a result, total debt now stands at over $3 trillion and is projected to reach $5 trillion in 1995. (See figure 4.)

Figure 3: Debt Held by the Public (1960-1990)

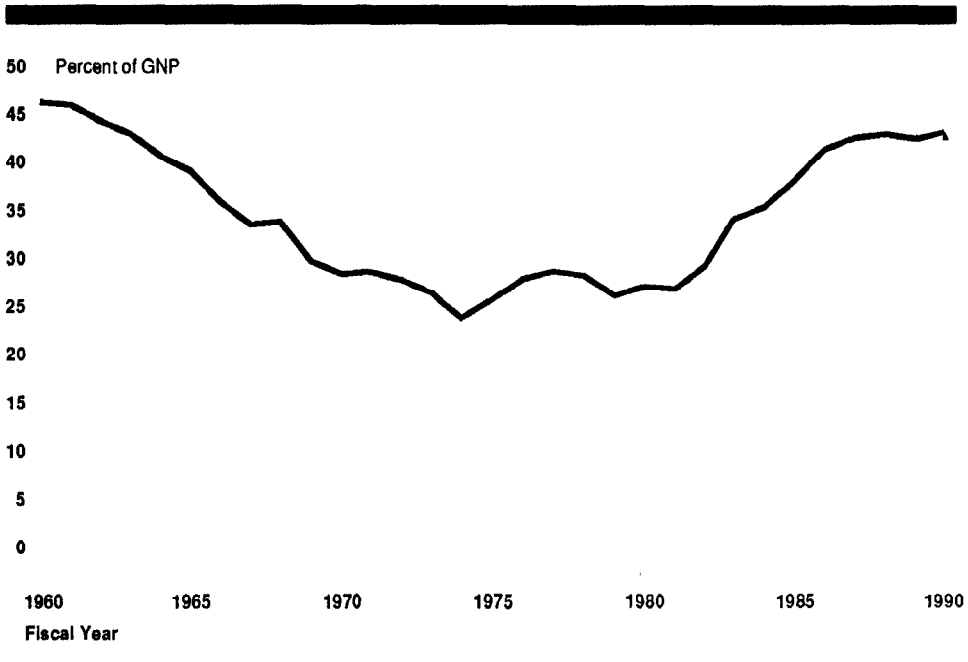
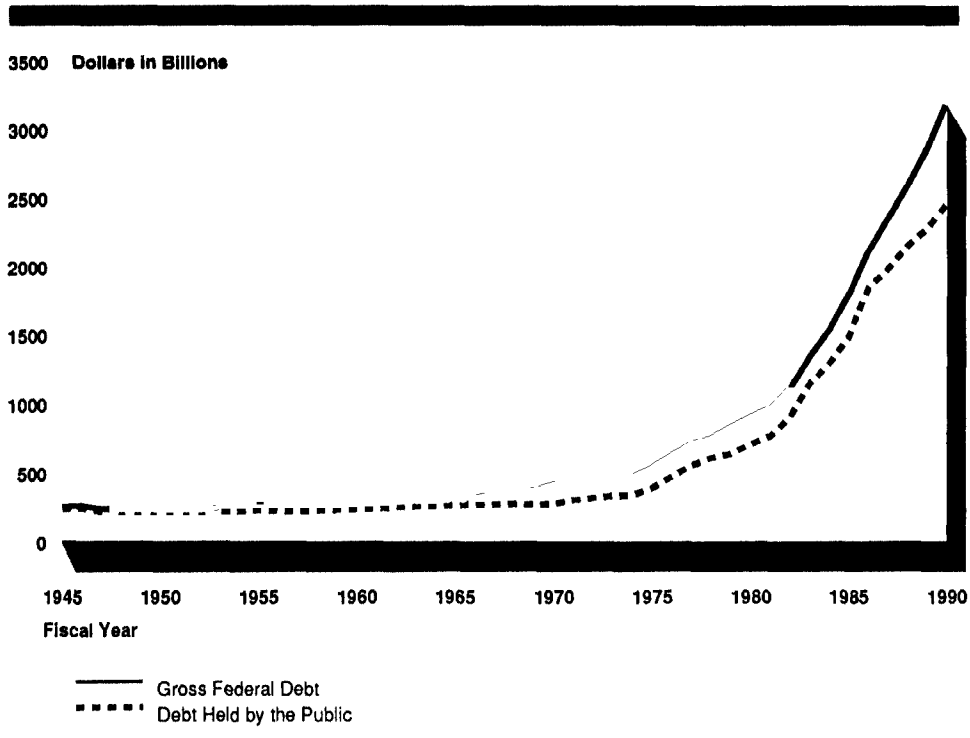


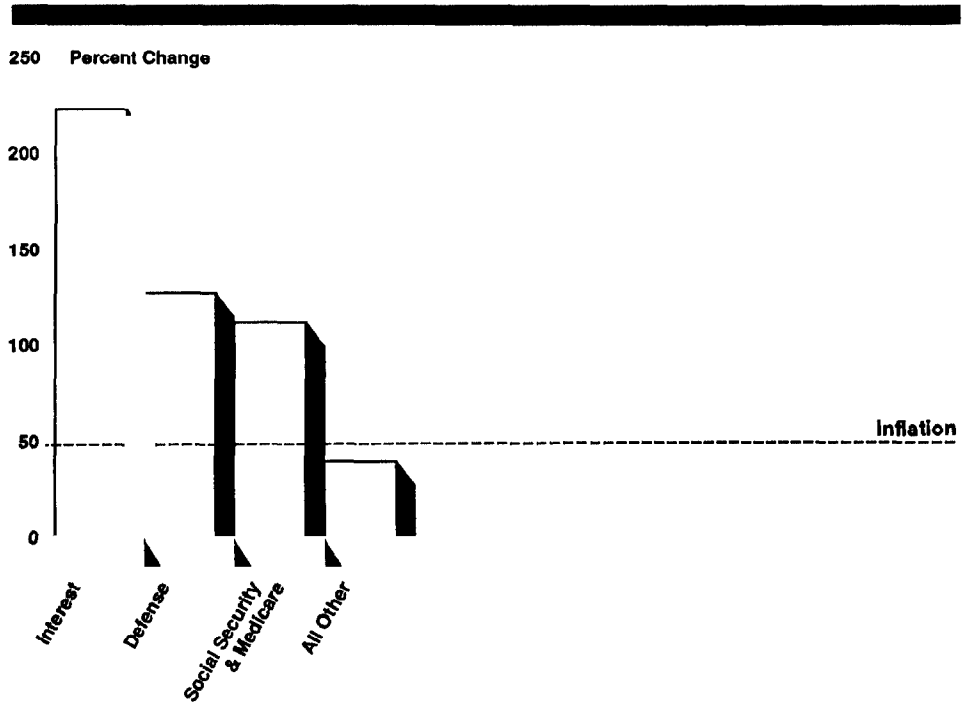
Figure 4: Gross Federal Debt and Debt Held by the Public (1945-1990)



Interest Costs

The huge increases in the debt have been reflected in the rapid growth of interest payments. Gross interest, including interest payments for funds borrowed from Social Security and other trust funds, increased by 222 percent from 1980 to 1989 and is the fastest growing expenditure in the budget. (See figure 5.) Current projections indicate that debt service costs will replace defense as the largest item in the budget by 1992.

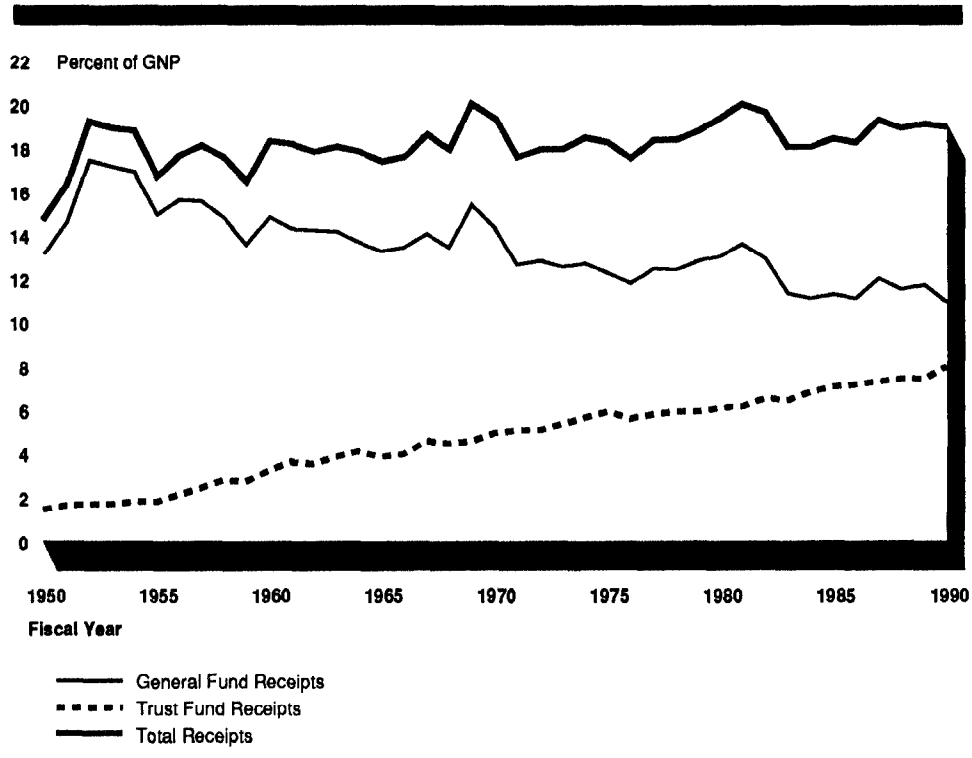
Figure 5: Increases in the Budget Compared With Inflation (1980-1989)



Funding Sources

A dramatic shift in the way federal programs are financed, as seen in figure 6, helps to explain the current underfunding of the government's general operations. In 1990, general fund receipts covered only 67 percent of general fund outlays. This reflects the fact that excise taxes and corporation income taxes, which support general operations, have declined significantly as a source of federal revenue—from 25 percent of the total in 1970 to 13 percent in 1990. Individual income taxes, which also support general operations, have remained about the same, both as a percent of receipts and as a percent of GNP. Until the 1980s, the Social Security trust fund was kept in approximate balance, but it recently has begun running large surpluses. This has been possible despite large increases in benefit payments for a simple reason: the Social Security tax share has almost doubled, from 20 percent to 34 percent of federal revenues. In short, the trust fund part of the budget has operated on a pay-as-you-go basis, but the general fund has not.

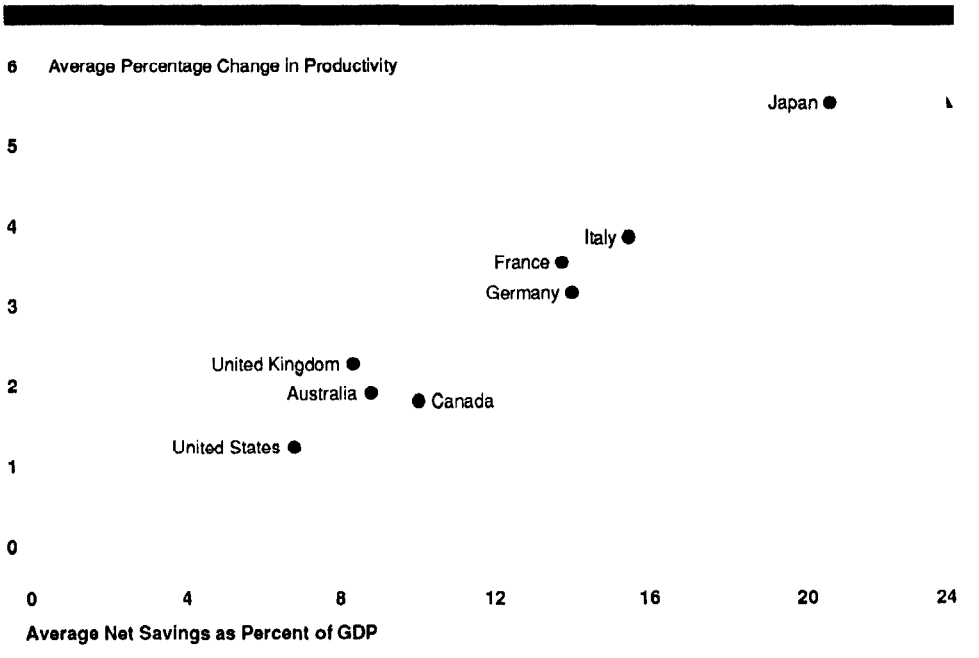
Figure 6: General Fund and Trust Fund Receipts (1950-1990)



Consequences

These huge deficits are draining the pool of the nation's savings, which is already historically low. Net savings in the United States have declined from about 9 percent in the 1960s and 1970s to 3.7 percent from 1980 to 1987. The U.S. savings rate is 40 percent of Germany's and only 20 percent of Japan's. As the correlations in figure 7 suggest, this has ominous implications for economic growth.

Figure 7: Countries With High Net Savings Experience High Productivity Growth (1960-1987)



Investment is financed from two sources, domestic savings and capital from abroad. With the decline in domestic savings and with the budget deficit absorbing a large portion of the savings that remain, the United States has come to depend increasingly on foreign capital. During the past decade, the United States has moved from a net creditor position to a net debtor position, transferring enormous wealth to foreign investors in the process. Investment financed overseas is better than none, but it results in foreign ownership of the assets. This means that future generations must pay for these investments in dividends and interest to the foreign owners. If allowed to go unchecked, this practice will seriously erode the nation's future standard of living.

The ultimate consequences of the deficit, therefore, are lower economic growth and a weak competitive position in the world. Without the domestic savings needed to support investment, growth is bound to suffer. The lesson is clear: those who grow are those who save.

Solution

The Size of the Job

It is evident, then, that current fiscal policy involves high risks to our nation's competitive position and major long-term costs in the form of low growth. The most desirable alternative, however, is less obvious. In establishing that alternative, we were primarily concerned with the need to restore the national savings rate over the next few years, thereby restoring the potential for internally generated and financed investment to levels the nation has achieved historically and that can sustain the long-term growth it needs. Our analysis indicates that the U.S. government should move the budget from its current 4 percent of GNP deficit to a surplus of 2 percent of GNP over 6 years. If this shift in fiscal policy is accomplished by 1997, it will yield an overall budget surplus in that year of about $180 billion and would bring the general fund close to balance.

In defining that goal, we considered the following:

- Current economic indicators suggest a weakening of the economy. This suggests caution in the timing of short-term fiscal policy changes.
- The situation in the Middle East calls for prudence in shaping short-term defense budget decisions while accentuating the need to reassess the forces needed to meet future post-Cold War threats.
- Achieving the significant shift in fiscal policy that we believe is essential will require substantial changes in spending policies, revenue policies, or both. Such changes should be carefully thought out and phased in over long enough periods to avoid shocks and disruptions.
- Fiscal policy shifts should be limited in size and speed so that they will not create unnecessary short-term risks to the economy.

We urge the administration and the Congress to consider alternatives that take all of these factors into account but not to use them as an excuse for postponing action. None of them changes the size or nature of the long-term fundamental problem the country faces.

We recommend that the Congress and the President reach agreement on a multiyear plan to move the general fund budget to approximate balance by 1997.

Our analysis indicates that a 6-year phased program that would begin to reduce the deficit by $50 billion in the first year and by $300 billion in

the final year represents an ambitious but practical attack on the problem. By 1997, this would consist of $240 billion in policy changes and $60 billion in savings from less borrowing. A sustained program of this magnitude should permit substantially lower interest rates; as a result, the lower costs of financing the federal debt might produce an interest rate "bonus" of another $60 billion by 1997.

The 1990 Budget Summit

As this report is being prepared for publication in late August 1990, budget summit negotiations are about to resume. Published reports indicate that the negotiators are seeking to reach agreement on a deficit reduction package of about $30 billion to $50 billion for fiscal year 1991, with a longer term cumulative goal of about $500 billion over the 5-year period from fiscal years 1991 through 1995. These goals are considerably more modest than we believe necessary. If achieved, they would be only a first step toward the more demanding goal recommended in this report, which would involve $1,050 billion in deficit reductions over a 6-year period. (On a fully comparable basis, our goal would be $500 billion by 1995, with another $250 billion in 1996 and $300 billion in 1997.)

Risks

The risks of this program are short-term and low, but the benefits are long-term and substantial. Although we share the general concern about an economic slowdown, the fundamental change in fiscal policy discussed here is not likely to impair seriously short-term growth. What these policies should do is yield lower interest rates, stronger investment, higher exports, and a significantly higher rate of economic growth by the end of the century.

Role of Debt Financing and Interest Rates

There are three basic aspects to deficit reduction:

- policy changes, that is, cuts in spending programs and increases in revenues from changes in the tax code;
- interest savings due to the lower size of the debt; and
- interest savings due to lower interest rates that should accompany a more restrictive fiscal policy.

By 1997, we believe that $242 billion in program cuts or revenue increases will yield $120 billion in additional savings because of lower debt and interest rates, as shown in table 1.

Table 1: The Arithmetic of Deficit Reduction for 1992 Through 1997

Dollars in billions

	1992	1993	1994	1995	1996	1997	Total
Adjusted baseline							
Total deficit	$−251	$−217	$−181	$−185	$−186	$−180	
Changes:							
Fiscal policy shift:							
Policy changes	48	93	135	173	209	242	**900**
Debt service savings from policy change	2	7	15	27	41	58	**150**
Total fiscal policy shift	**50**	**100**	**150**	**200**	**250**	**300**	**1,050**
Interest rate "bonus"	12	22	35	48	55	62	**234**
Total change from baseline	62	122	185	248	305	362	**1,284**
Baseline after policy change							
Total Surplus or Deficit	**$−189**	**$−95**	**$4**	**$63**	**$118**	**$182**	

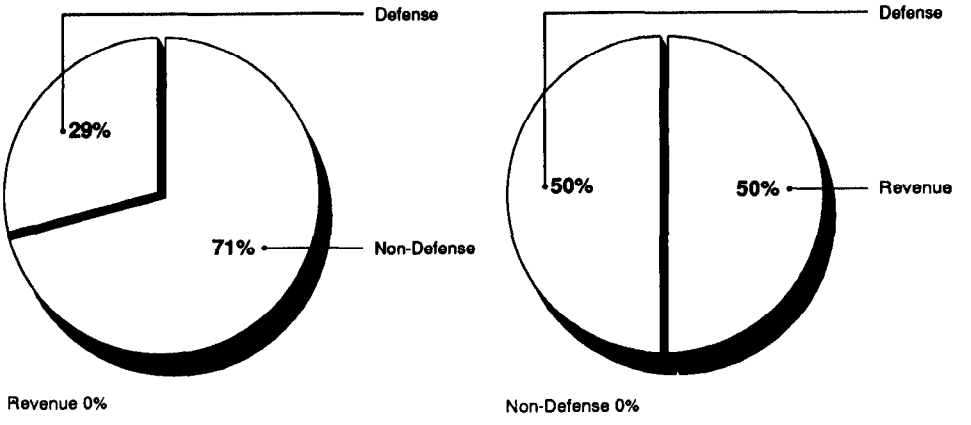
Note: Totals may not add due to rounding.

Alternatives

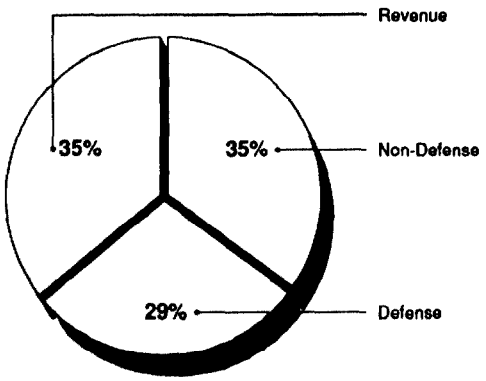
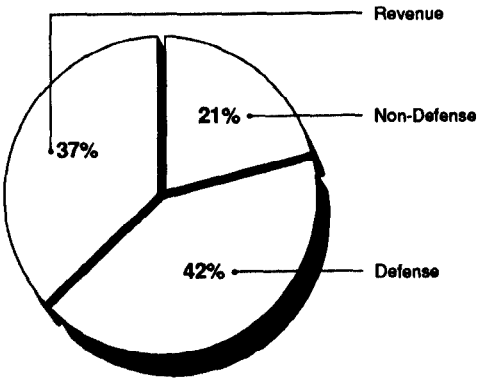
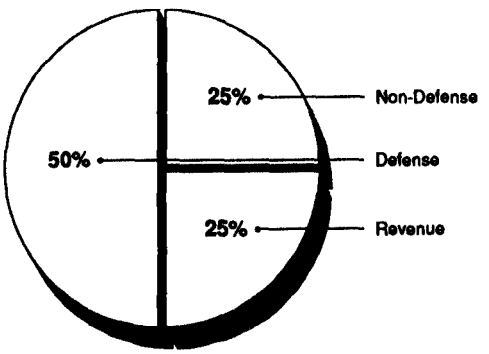
Developing a package of $240 billion in policy changes, yielding total deficit reductions of about 1 percent of GNP per year, is a major political challenge. However, several advanced industrialized countries, such as Australia, Denmark, and Sweden, have achieved deficit reduction in excess of this goal. As a nation, we must make basic choices about how much to allocate to defense and domestic programs. We then need to balance that spending with adequate revenues to avoid draining the supply of domestic savings. With the economy operating near capacity, debt financing is not a lesser burden to the nation than taxes, only a less visible one. It is also much more costly. This is observable from the fact that 17 percent of federal taxes now goes for interest payments. Indirectly, it either forces a reduction of investment in the economy or requires borrowing abroad, or both.

Each of these broad choices leads to a large number of more detailed ones. We do not advocate any one set of choices. Doing so would involve basic value judgments about the relative size of the public and private sectors and the role of government in our society, which should be made by elected officials. We, however, are suggesting options to be considered, five of which are illustrated in figure 8. In very general terms, these options present combinations of defense cuts, domestic cuts, and revenue increases for consideration.

Figure 8: Illustrative Deficit Reduction Programs



	Package #1	Package #2
Defense reductions (See chapter 5)	$70 billion Force structure reduction of up to 25 percent.	$120 billion Even greater force structure reduction.
Nondefense reductions (See chapter 6)	$170 billion Retain only core functions: law enforcement, tax collections, etc., plus low income support and activities funded with user charges and earmarked taxes. Tax 85 percent of Social Security benefits.	None
Revenue increases (See chapter 7)	None	$120 billion. Large tax rate increases elimination of many deductions and taxation of income now exempt, or a new comprehensive consumption tax (VAT).

Package #3	Package #4	Package #5
		
$70 billion	$100 billion	$120 billion
Force structure reduction of up to 25 percent.	Force structure reduction of more than 25 percent.	Even greater force structure reduction.
$85 billion	$50 billion	$60 billion
User fees; program cuts; and devolution of functions to states with reduced federal funding.	User fees; cuts in subsidies to business, individuals, and farmers; health care cost containment; federal workforce efficiency measures.	User fees; cut subsidies to business, individuals, and Medicare; curtail foreign aid; federal workforce efficiency measures.
$85 billion	$90 billion	$60 billion
Excise taxes, plus gasoline or energy tax, plus increased income tax rates.	Excise taxes, plus gasoline or energy tax, plus increased income tax rates.	Gasoline or energy tax and excise taxes, or increased income tax rates.

Note: Packages are illustrative only. Deficit reduction could be achieved in many ways. For example, defense savings could be accomplished by slowing down modernization, or by making disproportionate cuts in some forces to minimize reductions in others. Income tax rate increases can be minimized by heavier reliance on gasoline or energy taxes, or by taxing income currently exempt.

In chapter 4, this analysis is expanded to 15 combinations, which are summarized in table 2. Later chapters illustrate more specifically three defense reduction packages, four packages of domestic spending cuts, and three alternatives for increasing revenues.

Table 2: Basic Choices for Deficit Reduction (Changes From the 1997 Baseline)

Dollars in billions

	Policy Changes					
Policy sets	**Defense**	**Nondefense**	**Revenues**	**Total policy change**	**Debt service savings**	**Total fiscal policy shift**
Set 1	$70	$85	$85	$240	$60	$300
	70	60	110	240	60	300
	70	110	60	240	60	300
	70	170	0	240	60	300
	70	0	170	240	60	300
Set 2	100	70	70	240	60	300
	100	50	90	240	60	300
	100	90	50	240	60	300
	100	140	0	240	60	300
	100	0	140	240	60	300
Set 3	120	60	60	240	60	300
	120	45	75	240	60	300
	120	75	45	240	60	300
	120	120	0	240	60	300
	120	0	120	240	60	300

Other Issues

The last three chapters of this report consider issues involving enforcement of a budget agreement, recommend reforms in the budget process that would move us beyond mechanistic approaches such as GRH, and discuss the need to improve financial management so that the federal government funds will be used prudently and effectively.

Conclusion

In the final analysis, a new fiscal policy is essential to the economic well-being of the United States. Not only must the federal government find the will and the way to confront the deficit crisis, it must also encourage savings that will promote economic growth, ease and eventually end U.S. dependence upon foreign capital, and provide the means to deal with future needs as they arise.

As this report shows, there are many possible alternatives available to the Congress and the administration. Each of these alternatives involves some short-term sacrifice, depending upon the choices that are selected by elected officials. Such sacrifice, however, would be far outweighed by the long-term benefits that would flow from a multiyear budget solution agreed to on a bipartisan basis by both the Congress and the administration.

Contents

Figures

Abbreviations

AGI	adjusted gross income
CBO	Congressional Budget Office
CFO	chief financial officer
COLA	cost-of-living adjustment
DOD	Department of Defense
FSLIC	Federal Savings and Loan Insurance Corporation
GDP	gross domestic product
GNP	gross national product
GRH	Gramm-Rudman-Hollings
IRA	individual retirement account
IRS	Internal Revenue Service
JCT	Joint Committee on Taxation
NNP	net national product
OECD	Organization for Economic Cooperation and Development
OMB	Office of Management and Budget
RTC	Resolution Trust Corporation
VAT	value-added tax

Introduction

This report responds to a request from Senators Exon and Grassley, who were subsequently joined by Senators Moynihan and Bradley. The request was stimulated by increasing concern about the budget deficit and about the need for greater public understanding of the problem. The requesters posed a broad ranging series of questions and asked us to respond based on our experience with and knowledge of government programs and finances. Their questions centered on

- the outlook for the budget deficit and the public debt,
- the selection of an appropriate fiscal policy for the nation, and
- the budgetary choices that the Congress and the President must face if that fiscal policy is to be achieved.

In response to these questions, we have set forth our views on the dimensions of the budget problem faced by the nation, the implications of the deficit for the performance of the U.S. economy, and the alternatives that are available to solve the deficit problem.

Context of the Request

The request grew out of the recognition, in the spring of 1990, that the federal budget deficit had gone out of control. Table 1.1 displays this sudden explosion of the deficit as seen in re-estimates of the budget by the Congressional Budget Office (CBO) and the Office of Management and Budget (OMB) between January and July of 1990. The dimensions of that growth are summarized in figure 1.1.

These revisions in the estimates reflected the escalating costs of the Resolution Trust Corporation (RTC), the agency responsible for resolving the bankruptcy of the Federal Savings and Loan Insurance Corporation (FSLIC), and declining tax revenues from a softening economy.

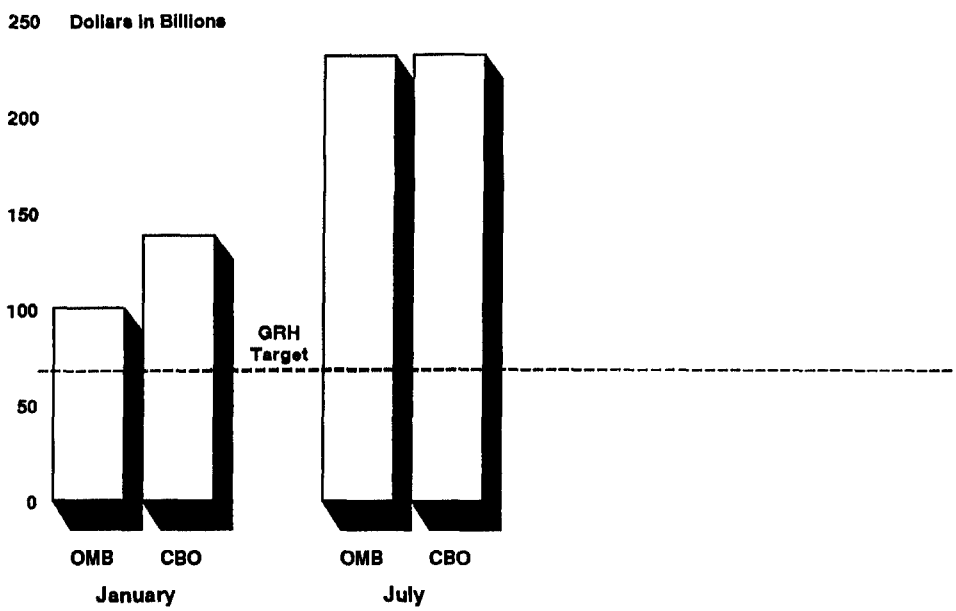
Overruns had occurred before, though never on this scale. Still, the events of the spring of 1990 followed several years in which optimistic expectations for declining deficits, built on the assumption that Gramm-Rudman-Hollings (GRH) deficit targets would be met, were often disappointed when the actual financial results were unveiled. The resulting doubts about the government's ability to manage its financial affairs were greatly intensified by the new explosion of the deficit in 1990. It was in this environment that the requesters asked us to examine the issues.

Table 1.1: Changing Deficit Estimates for 1990 and 1991

Dollars in billions

	Fiscal year			
	1990		1991	
Deficit estimate	**CBO**	**OMB**	**CBO**	**OMB**
January 1990	$138	$122.0	$138	$100.5
Revisions:				
Resolution Trust Corporation	$22	$54.8	$65	$55.2
Lower revenue	23	28.8	14	34.6
Interest	2	5.8	11	21.3
Other	10	7.1	4	19.8
July 1990	$195	$218.5	$232	$231.4
GRH target	$100	$100.0	$64	$64.0
Excess deficit:				
January	$38	$22.0	$74	$36.5
July	$95	$118.5	$168	$167.4

Figure 1.1: Changing Estimates for Total Deficit



Structure of the Report

The report is structured around the questions that were posed to us. Chapter 2 describes the background of the present deficit problem. It includes a recent history of the budget, an examination of the factors that led to the explosion of deficits in the 1980s, and a projection of the future course of the deficit if nothing is done to contain it. Chapter 3 examines the economic implications of continued large deficits and of efforts to reduce them. This analysis concludes that restoring the prospects for long term economic growth requires a shift in fiscal policy of about $300 billion by 1997, yielding a total budget surplus of about $180 billion at that time, about 2 percent of gross national product (GNP).

That shift in fiscal policy can be achieved in numerous ways. It was our task to describe a representative range of the choices that are available. Chapter 4 arrays the defense, nondefense, and revenue choices that must be considered. We stress the key part in the arithmetic of deficit reduction played by debt service costs, now the second largest spending component in the budget and gaining rapidly on defense for the number one position. We then describe various hypothetical packages of policy changes, involving varying combinations of defense and nondefense budget reductions and revenue increases. We take no position on which would be preferable. That requires value judgments that must be made by elected officials.

We then examine in greater detail the program choices within each category: defense (chapter 5); nondefense (chapter 6); and revenues (chapter 7). The program and revenue choices that are posed are intended to define the range of options available to the Congress and the President, not to indicate our position on the wisdom of choosing a particular course of action. Detailed data underlying the options portrayed in these chapters, along with other technical and supporting material, are being published in GAO/OCG-90-5A which is a separate volume to this report.

The final section of the report focuses on procedural and structural questions. Chapter 8 discusses approaches to assuring that an agreement to reduce the deficit by substantial amounts would be implemented. In chapter 9 we suggest longer term changes in the budget structure and process that would help prevent future explosions of deficits such as those that occurred in the 1980s. The report concludes in chapter 10 with a discussion of the need for a major strengthening of the government's management systems and controls as part of a strategy for bringing government finances under control and for

assuring that whatever resources are allocated to the public sector are used efficiently and effectively.

The 1990 Budget Summit

As this report is being prepared for publication, in late August of 1990, budget summit negotiations are about to resume. Because of the uncertainty surrounding the negotiations, we have not reflected their outcome in the baseline for this report. Published reports indicate that the negotiators are seeking to reach agreement on a deficit reduction package of $30 billion to $50 billion for 1991, with a longer term goal of about $500 billion over the 5-year period, 1991 to 1995.

If these reports are accurate, the current goals of the summit negotiators are considerably more modest than we believe necessary. If achieved, they would be only a first step toward the more demanding goal recommended in this report, which would involve $1,050 billion in deficit reduction over a 6-year period. (On a fully comparable basis, our goal would be $500 billion by 1995, with another $250 billion in 1996 and $300 billion in 1997.)

Next Steps

We recommend that as the first order of business of the 102nd Congress (or sooner, if possible), negotiations should resume between the President and the bipartisan leadership of the Congress with the objectives of

- reaching agreement on a comprehensive package of policy changes that will produce an overall budget surplus of about 2 percent of GNP (about $180 billion) by 1997; and
- enacting those changes into law in the form of a multiyear budget resolution, along with the substantive legislation required to implement that resolution, by the conclusion of the First Session of the 102nd Congress.

Chapter 4 provides a framework for developing that package of policy changes, and chapters 5 through 7 provide a basis for examining the choices that must be made.

Objectives, Scope, and Methodology

The objective of this report is to respond to the questions posed by the requesters. The methodological approach varies from one section of the report to another, depending on the issues being addressed. The historical background relies heavily on published data from OMB and CBO. The outlook for the deficit and the debt begins with the baseline projections for 1991 to 1995, which CBO published in July 1990. With assistance

from CBO, we extended these projections to 1997, using standard CBO methodology. We then adjusted the extended projections by assuming that, in the absence of a deficit reduction program, interest rates would remain at their present levels.

The economic analysis section of the report is grounded in standard economic theory. The conclusions and recommendations with respect to fiscal policy were tested using recognized econometric forecasting techniques. The results of these simulations are presented in greater detail in appendix I of a separate volume to this report, GAO/OCG-90-5A.

The section of the report describing alternative policy choices for accomplishing the needed shift in fiscal policy relies on various data sources, including data published by OMB and CBO, and data we obtained from the agencies whose programs are discussed. We selected particular options to illustrate the range of choices available to the Congress and the President based on our work in various program areas. The inclusion of an item is only illustrative of the many choices that could be made, not a recommendation that a particular choice should be made.

The section of the report dealing with needed changes in budget practices was developed by us from our previous work in this area and our observation of the budget process over many years.

Drafts of this report were reviewed by a number of outside advisors who were selected for this purpose on the basis of their expert knowledge of particular issues. We sought a diversity of views on the various issues and, as would be expected, received conflicting advice on many of them. Time did not permit us to seek official agency views on these issues.

The analysis in this report reflects data available in the period from May through August of 1990.

Note on Terminology

Throughout this report, we use the term "general fund" in lieu of the "federal funds" description found in most official budget documents. We concluded that this would facilitate public understanding because "federal funds" is not a term often found in common usage.

Background

This chapter provides a context in which to understand the nature of the deficit problem and a backdrop against which to consider the policy choices presented later in the report. We first review the recent history of budget performance. We then discuss the possible future course of the budget deficit and the public debt in the absence of an aggressive effort to control them.

Recent Budget History

The pattern of budget deficits since World War II is displayed in figure 2.1, reflecting annual data in current dollars. Figures 2.2 and 2.3 are more revealing about underlying trends because they relate the deficits to a growing economy and avoid the distorting effects of price changes over long periods. These demonstrate that the annual deficits in the 1980s, while dramatically larger than in earlier periods, are an extension of a pattern that began much earlier. That pattern, as seen in figure 2.2, shows the average deficit as a percent of GNP in each decade since the 1950s to be roughly double the average of the previous decade.

Figure 2.1: Total Budget Deficits (1947-1990)

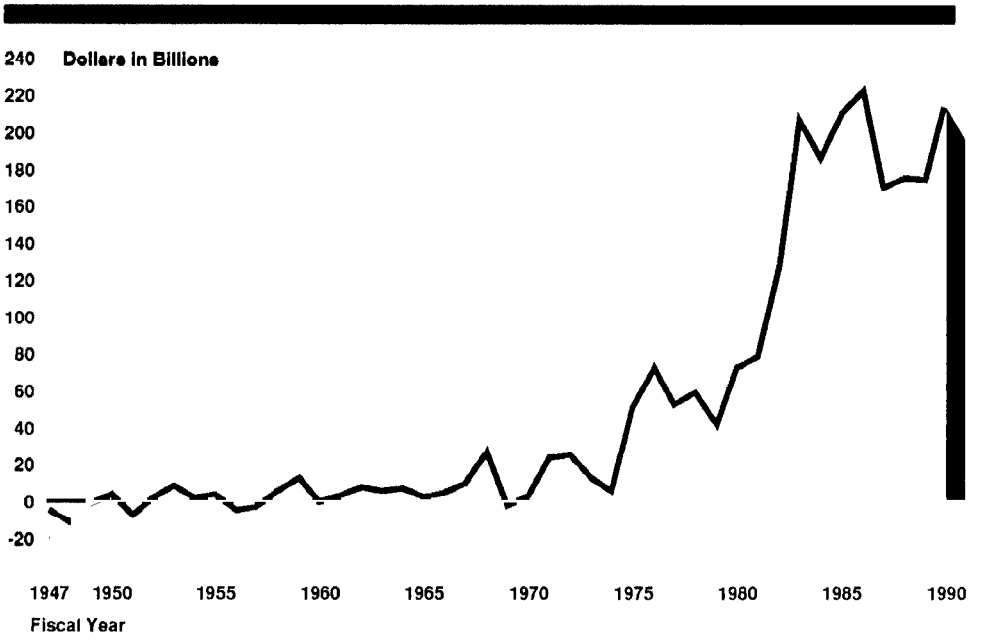
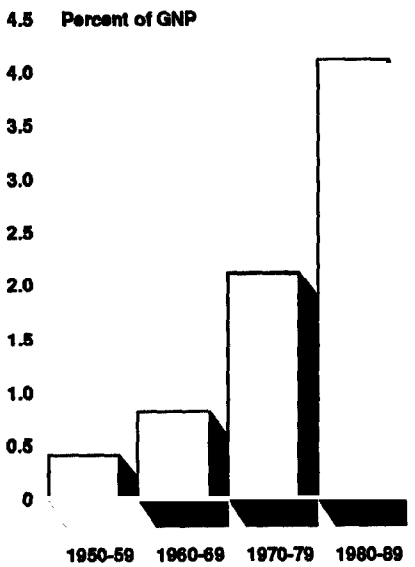
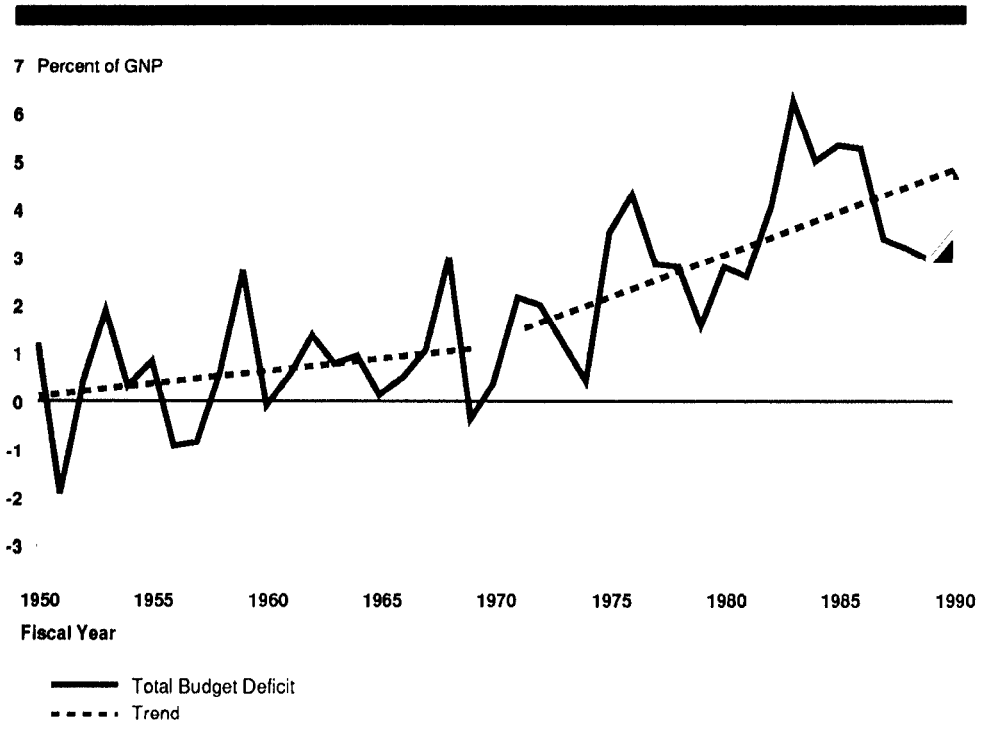


Figure 2.2: Average Deficit by Decade (1950-1989)



In figure 2.3, a long-term trend line has been fitted to the annual data, and that trend line shows a disturbingly steep upward slope since the 1950s. The slope grew even steeper after 1970. It seems evident that some forces are at work that are not adequately explained by focusing exclusively on events in the 1980s, critical as those events are in understanding our current problems.

Figure 2.3: Total Budget Deficits (1950-1990)



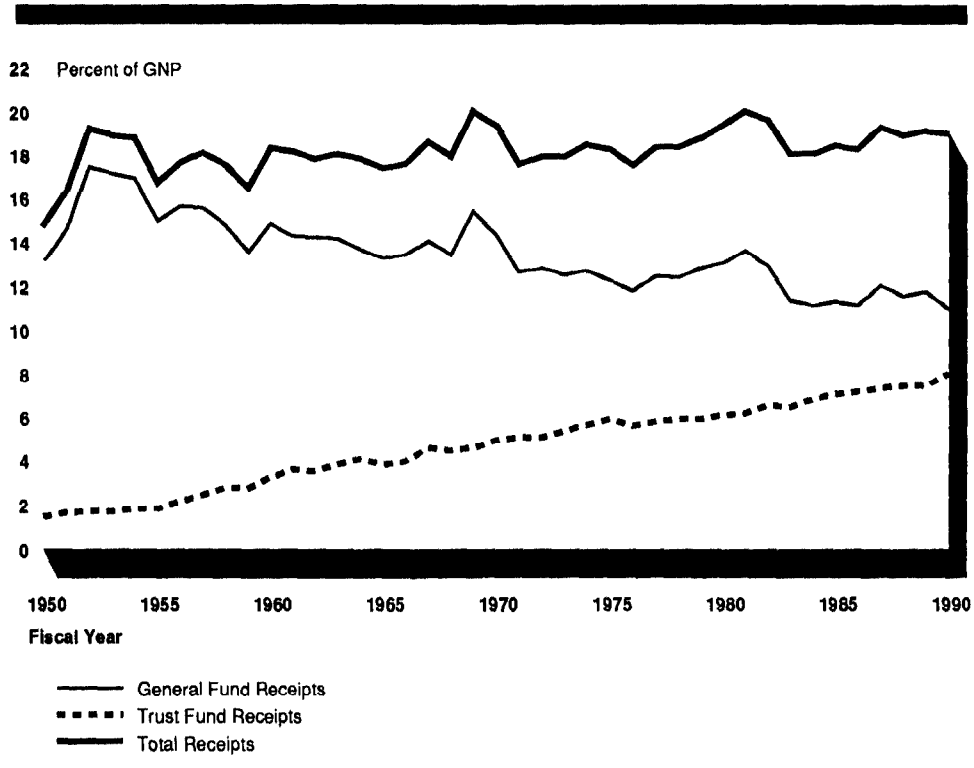
Components of the Long-Term Trend

To understand what has happened to the budget over the years, it is necessary to focus on two major components of the budget. One is the general fund, which finances most of the general operations of government, primarily from unearmarked revenue sources such as the individual and corporate income tax. (In official budget documents, this is called the "federal funds" part of the budget. We use the label "general fund" because of its greater familiarity in common usage.) The other major component of the budget is the trust funds, in which certain programs are financed from dedicated revenues. Social Security, financed by payroll taxes, dominates this component, along with Medicare and the Civil Service and Military Retirement funds.

Each year's budget deficit, of course, is simply the difference between revenues and outlays in that year. Thus, to find the source of the long-term trend toward larger and larger deficits, we must look at the trends in revenues and outlays. Figure 2.4 displays revenues, again in relationship to the total economy. Two things are of special significance. One is the long-term stability of total revenues in relation to the economy. While there is significant year-to-year variation, total revenues have remained consistently within a close range around 18 to 19 percent of

GNP since 1960. Equally notable, however, is the shifting composition of those revenues, with a steadily declining share going to the general fund and a rising portion going to the trust funds, primarily to Social Security.

Figure 2.4: General Fund and Trust Fund Receipts (1950-1990)



Next we must look at what has happened on the outlay side of the budget. This is seen in figure 2.5, in which total outlays rise fairly steadily. Again, however, the composition is important. General fund outlays remained relatively stable at around 15 to 17 percent of GNP until recent years, when growing interest costs began to raise the trend line. Trust fund outlays, on the other hand, rose steadily in the earlier years, but have leveled off recently. From this brief examination, it is clear that the two major components of the budget—the general fund and the trust funds—have behaved very differently over the years. This is demonstrated in figure 2.6, which separates the deficits into their general and trust fund components. The long-term trend toward rising deficits is obviously centered in the growing structural imbalance in the general fund.

Figure 2.5: General Fund and Trust Fund Outlays (1960-1990)

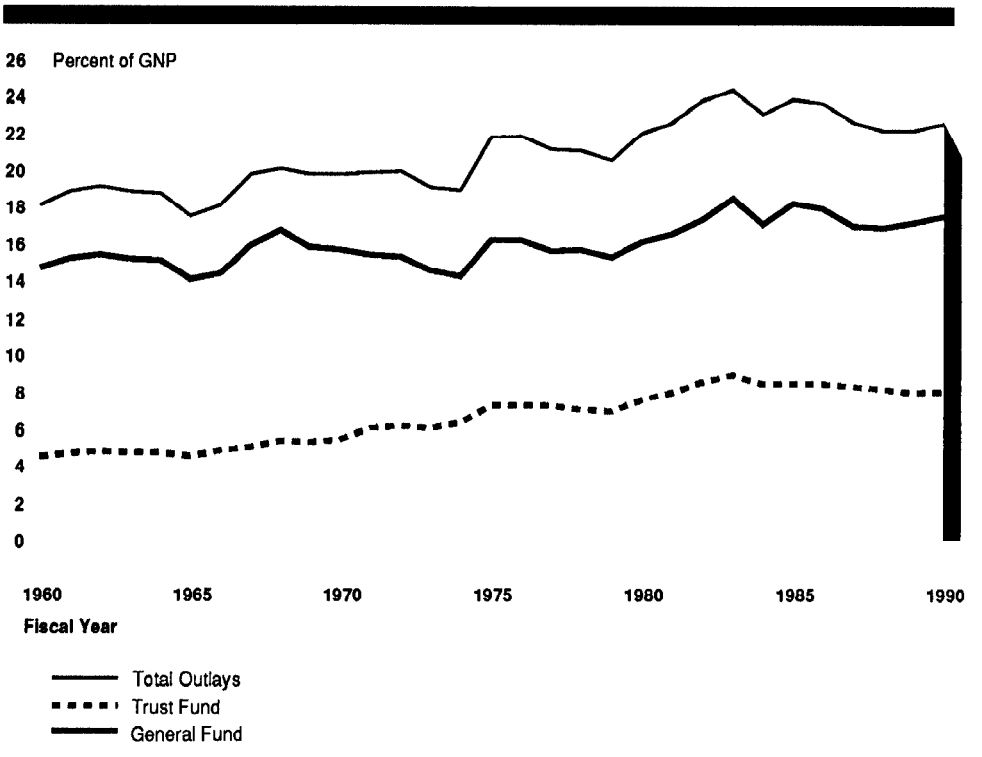
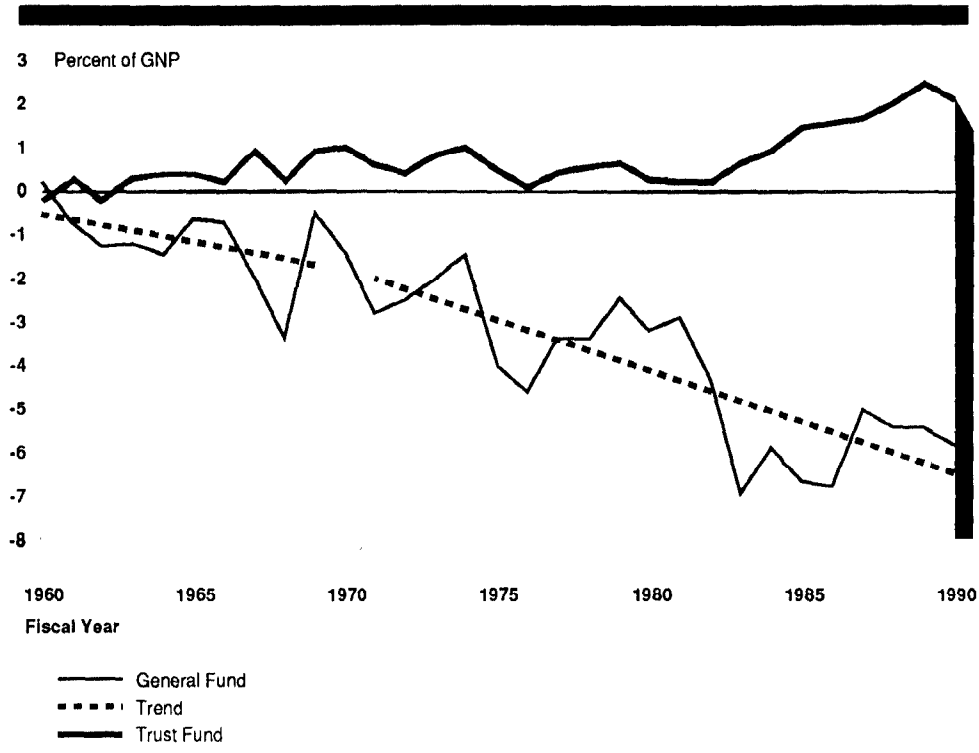


Figure 2.6: General Fund and Trust Fund Deficits/Surpluses (1960-1990)



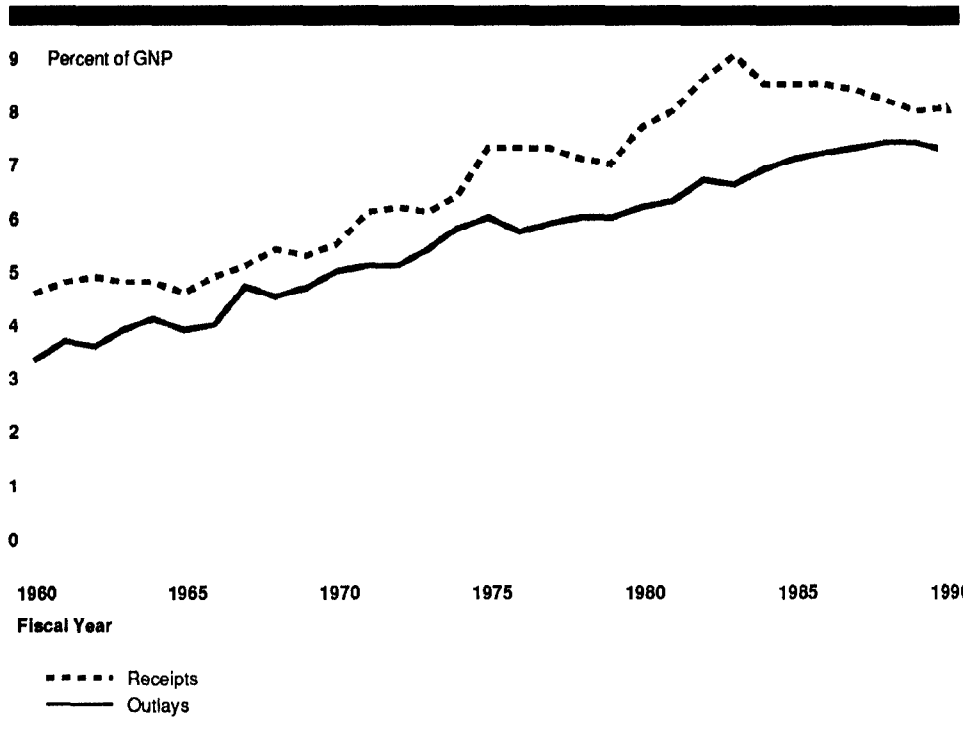
Thus we see that, over the years, trust fund outlays have risen, and a growing share of a relatively stable flow of total revenues has been allocated to the trust funds to finance those outlays. This is exemplified by legislation in the early 1980s, which increased the payroll tax to begin building substantial reserves in the Social Security trust fund while reducing individual and corporate income taxes. But the reduced flow of revenue to the general fund was not matched by a comparable reduction of claims on that revenue. Instead, total general fund outlays continued along the previous path and we borrowed the difference. To deal with this persistent deficit, we must either increase general fund revenues, or reduce general fund outlays, or both. Therefore, we need to focus on what has happened in recent years within the general fund part of the budget.

Recent Performance of Trust Funds

Before turning to the general fund, however, we should look briefly at the trust funds, and especially at Social Security, which dominates the trust fund part of the budget. Until about 1980, the Social Security program was financed on a "pay-as-you-go" basis, under which payroll

taxes were set at levels designed to finance current benefits and administrative costs plus a small allowance for contingencies. Thus, as outlays rose over the years, revenues rose in lock step. This can be seen in figure 2.7, showing the relationship between trust fund revenues and outlays.

Figure 2.7: Trust Fund Receipts and Outlays (1960-1990)



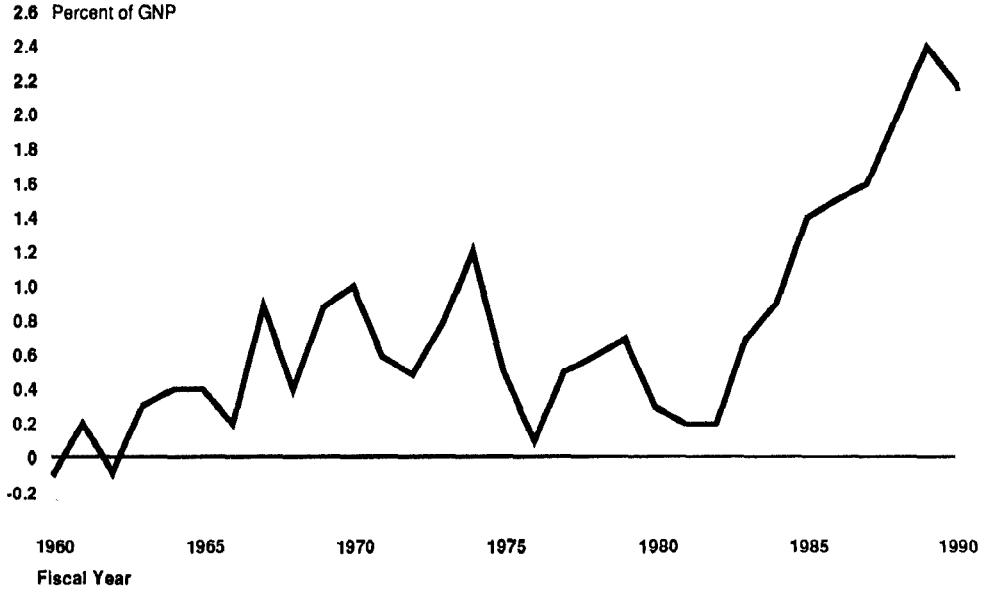
By the late 1970s, it was apparent that the prospective retirement of the "baby boom" generation, anticipated to begin by the second decade of the 21st century, combined with a dramatically lower birth rate since the 1960s, was pushing the Social Security fund into serious imbalance over the 75-year actuarial estimating period used for the program. In response, previously scheduled increases in the payroll tax were accelerated in order to restore reasonable actuarial balance. But the events that these taxes were intended to finance lay several decades in the future. Thus, the higher payroll taxes began quickly to produce revenues well in excess of the amounts needed to pay current Social Security benefits. Under current law, the resulting surpluses will continue accumulating for another 30 years or so, but will then be drawn down rapidly as the "baby boom" generation retires. The accumulated reserves will be exhausted by about 2050 under current actuarial projections.

These surpluses in the Social Security fund began accumulating at the same time the government started moving toward full funding of its civilian and military retirement programs, producing surpluses in those trust funds as well. The consequences are evident, as displayed in figure 2.8, which shows total trust fund surpluses that were more than 2 percent of GNP in the late 1980s and continuing to grow. For the first time, the trust funds' performance became a major factor in the budget's overall performance and thus in the nation's fiscal policy.

But these trust fund surpluses were matched by even larger general fund deficits. Since trust fund surpluses are invested in the Treasury bonds that finance the general fund deficit, the net result is that the trust funds are financing a significant portion of that deficit.

This is the basis for a special concern with respect to Social Security. The present situation, in which the trust fund surpluses are combined with and partially offset a deficit in the general fund, means that the payroll tax is being used, not to make provision for future retirement benefits, but to pay for today's general operations of government. The rationale for increasing the payroll tax, however, was to enable Social Security benefits to be paid to retirees in the next century without overburdening tomorrow's workers. This can only be accomplished if Social Security surpluses are accumulated as additions to the nation's supply of savings.

Figure 2.8: Trust Fund Surpluses
(1960-1990)



Our earlier report on the Social Security trust fund, Social Security: The Trust Fund Reserve Accumulation, the Economy, and the Federal Budget (GAO/HRD-89-44, January 1989), pointed out that this addition to savings should lead to higher productivity and more rapid economic growth. With faster growth, retirement benefits can be maintained for the baby boom generation while also maintaining a higher standard of living for future workers. This, however, requires approximate balance in the rest of the budget, without which the trust fund surpluses will continue only to finance the other operations of government. Therefore, the changes to Social Security enacted in 1983 are not producing the desired result of lessening the burden of paying the retirement benefits of the baby boom generation. The budgetary reality is that part of the payroll taxes are being used to finance the current operations of government. The economic reality is that the trust fund reserves, because they are financing current consumption rather than productive investment, are illusory. They will remain so until the rest of the budget achieves approximate balance.

As is apparent from this discussion, the problem of the budget deficit is centered in one part of the budget, the general fund, where a structural imbalance that began in the 1960s and 1970s grew to enormous proportions in the 1980s. This structural imbalance is not only a problem in

itself, it raises legitimate questions about the appropriateness of the current Social Security tax policy.

The General Fund in the 1960s and 1970s

We actually started the 1960s with a general fund surplus of $800 million. By 1970 that had shifted to a deficit of about $13 billion. That understates the extent of the change, however, because it followed deficits in the late 1960s that peaked at $28 billion, a huge amount by the standards of the time. By 1980, the general fund deficit had reached almost $83 billion, presaging the budgetary trauma of the next decade.

This secular trend reflects several factors, but the first key to the puzzle lies on the income side of the budget, in the stagnation of revenues from the corporate income tax and excise taxes. In 1960, these sources contributed revenue equal to 6.5 percent of GNP. By 1970, that was down to 4.9 percent. By 1980, it was only 3.3 percent, barely half the 1960 level. By contrast, individual income tax proceeds remained quite stable throughout the period, at about 8 to 9 percent of GNP. The economy's performance also affected revenues, as we went from the steady growth and low inflation of the 1960s to the tumultuous 1970s, with that decade's oil price shocks, accelerating inflation, and periods of stagnating growth.

On the outlay side, changes took place in how the money was spent but, as noted earlier, total general fund outlays remained in the range of 15 to 17 percent of GNP throughout the period. To examine these compositional changes, we must look separately at the 1960s and 1970s, because the explanations differ. In the 1960s, the dominant factor was rising defense spending, accompanied by relatively slow growth in other parts of the budget. This reflected the Kennedy administration's defense buildup, led by Defense Secretary McNamara, followed by the Vietnam War.

Despite President Johnson's commitment to social programs, the Great Society made its presence felt in the 1970s, not the 1960s. This can be seen by looking at seven benefit programs financed through the general fund

- Medicaid,
- the general fund subsidy for Medicare,
- the Food Stamp Program,
- the Special Supplemental Feeding Program,
- Supplemental Security Income,

- housing subsidies, and
- the Earned Income Tax Credit.

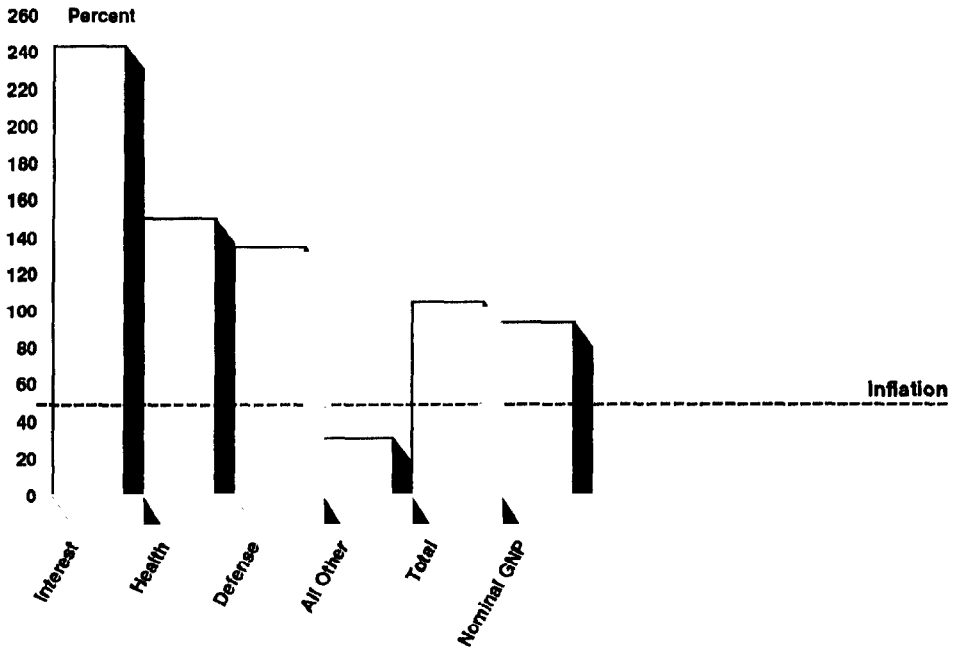
Of these, only the housing program existed in 1960, costing $140 million in that year. Medicaid, Medicare, and the Food Stamp Program were created in the 1960s, but the four programs existing in 1970 still cost less than $5 billion. By 1980, the other three programs had been established, and the total cost of the seven had reached $42 billion. Meanwhile, the defense budget was tightly constrained after the Vietnam War until the Carter administration began a rebuilding effort in the last years of the decade.

In one respect, the decision to allow some programs to expand (defense in the 1960s, benefit programs in the 1970s) while others were held back represented a lost opportunity to bring general fund spending in line with the available revenues. Looking at the issue another way, once government decided to spend the money, it should have provided the revenue to pay for that decision. Unfortunately, the failure to follow either course was only a precursor to the budget policy errors of the 1980s.

The General Fund in the 1980s

To see why general fund spending continued to rise in the 1980s in relation to GNP, notwithstanding the continuing downward trend in general fund revenues, it is necessary to look at the components of that growth, as shown in figure 2.9. Total general fund outlays rose by slightly over 100 percent from 1980 to 1989. Most of this growth can be found in three key areas. Defense more than doubled, increasing almost $180 billion, reflecting the Reagan administration's acceleration of the defense buildup that began under President Carter. Spending for health programs grew even more rapidly, but from a smaller base, contributing about $56 billion of the growth, mostly in Medicaid and in the general fund subsidy for Medicare.

Figure 2.9: General Fund Spending Growth (1980-1989)



The fastest growing piece of the general fund budget was interest on the public debt, which more than tripled during the decade and added almost as much to spending as did the defense budget increases. In the mid-1970s, interest costs were only about 12 percent of general fund spending; today they are at 25 percent and continuing to rise, as the need to service the rapidly growing debt, as seen in figure 2.10, consumes resources that otherwise would be available for more productive use.

Figure 2.10: Gross Federal Debt and Debt Held by the Public (1945-1990)

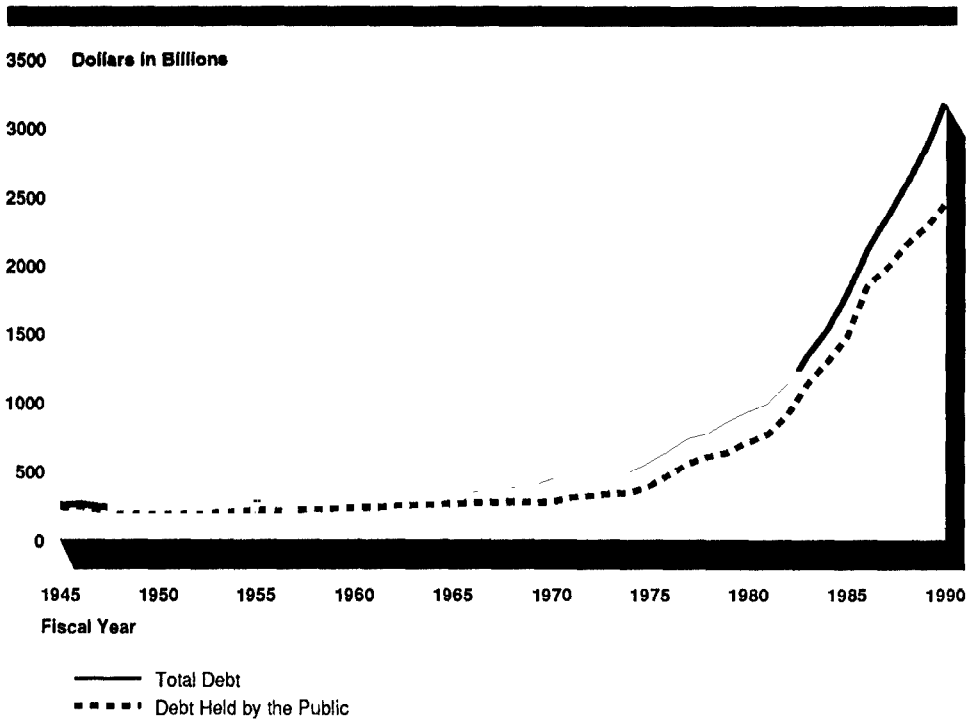
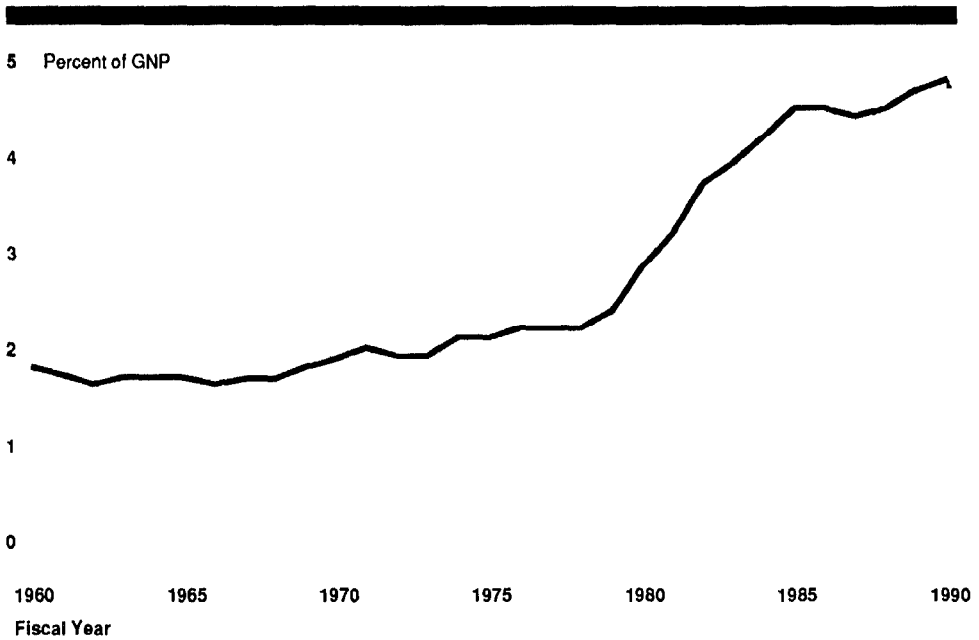


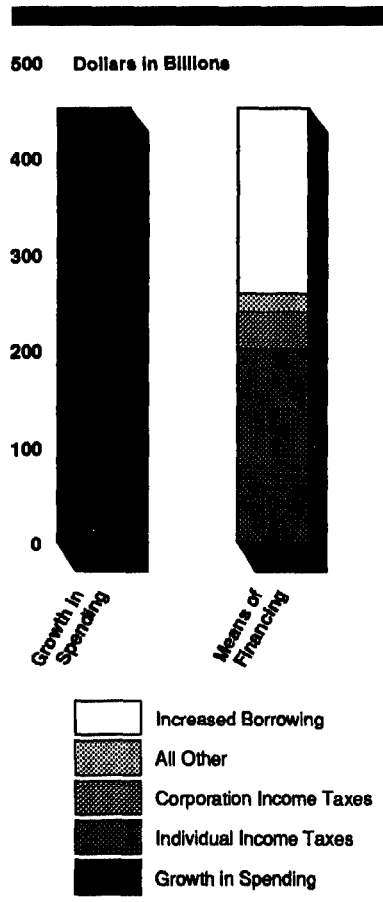
Figure 2.11: Gross Interest on the Public Debt (1960-1990)



As seen in figure 2.11, this growth of debt service costs, now rising again in relation to GNP, is the direct result of the deficits of the 1980s, along with the high levels of interest rates that have accompanied those deficits. All the rest of the general fund spending programs, taken together, grew at a very modest pace, less than the rate of inflation.

The performance of the revenue side of the general fund budget during the decade of the 1980s is shown in figure 2.12, displaying the gap between the growth of revenue and the growth of spending, a shortfall of almost $200 billion, that had to be financed by increased annual borrowing.

Figure 2.12: Financing the Growth in General Fund Spending (1980-1989)



The composition of the general fund revenue base also changed significantly during the 1980s. The revenue from income taxes almost caught

up with the growth of the economy, despite the rate reductions in the early 1980s. But other revenue sources fell well short of the rate of growth of the economy, continuing trends begun in earlier decades. By the end of the 1980s, the general fund was overwhelmingly dependent on the individual income tax, the source of almost three-quarters of general fund revenues. This is a marked contrast to the 1960s, for example, when the individual income tax represented less than 60 percent of general fund revenues.

The performance of the general fund in the 1980s, continuing in exaggerated fashion the trends starting in earlier decades, is cause for deep concern about the ability of the federal government to manage its finances. As the next section makes clear, the current outlook for the future is not encouraging.

Outlook for the Deficit and Debt

For fiscal year 1991, CBO estimates a baseline total deficit of $232 billion, including the outlays of the Resolution Trust Corporation. That total estimated deficit consists of a surplus of $73 billion in Social Security, a surplus of $62 billion in the other trust funds, and a deficit of $367 billion in the general fund. This estimate was developed according to the estimating procedures used for the GRH deficit reduction process. Those procedures are now used routinely by OMB and CBO in developing baselines for the budget process. CBO has projected the estimates through 1995, using the same procedures. With CBO's assistance, we extended those projections through 1997, to provide a baseline for the policy choices discussed in later chapters.

Adjusting the Baseline

The CBO baseline assumed (as requested by the congressional members of the budget summit negotiating group) that a major reduction in the deficit would be implemented. Based on this assumption, CBO concluded that interest rates would decline substantially and quickly from their present levels. This yields significant savings in debt service costs, and thus a deficit baseline significantly lower than would otherwise occur. For reasons discussed in chapter 3, we agree that interest rates are likely to decline significantly with the implementation of a substantial deficit reduction plan. However, for purposes of this report, we concluded that it would be preferable to portray the decline in rates as a potential additional benefit of an attack on the deficit, rather than as part of the baseline. Accordingly, we adjusted the CBO baseline to reflect an assumption that interest rates would remain at approximately their

present level in the absence of a major reduction in the deficit. The adjusted baseline that we used for this report is displayed in table 2.1.

Table 2.1: GAO Adjusted Baseline Budget Projections

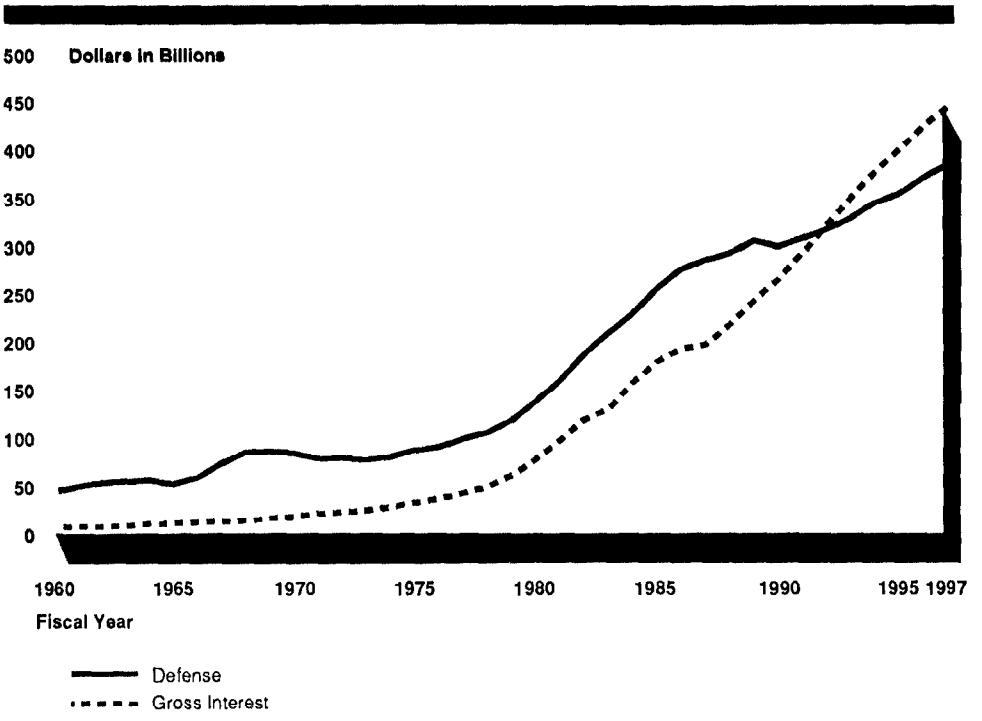
Dollars in billions

	Fiscal year							
Projection	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**
General fund:								
Revenue	$644	$689	$729	$774	$820	$869	$925	$985
Outlays	961	1,061	1,120	1,141	1,164	1,230	1,303	1,374
Deficit	$−317	$−372	$−391	$−367	$−344	$−361	$−378	$−388
Trust fund surpluses:								
Social Security	$59	$73	$83	$95	$109	$124	$140	$158
Other	64	62	57	55	54	52	52	50
Subtotal	$123	$135	$140	$150	$163	$176	$192	$208
Total deficit	**$−195**	**$−237**	**$−251**	**$−217**	**$−181**	**$−185**	**$−186**	**$−180**
Federal debt owed to:								
Social Security	$216	$289	$373	$467	$576	$700	$840	$998
Other government accounts	582	642	698	754	809	864	916	966
Subtotal	$799	$932	$1,070	$1,221	$1,385	$1,564	$1,756	$1,964
The public	$2,378	$2,612	$2,860	$3,077	$3,256	$3,442	$3,628	$3,809
Total Federal Debt	**$3,177**	**$3,544**	**$3,930**	**$4,298**	**$4,641**	**$5,006**	**$5,384**	**$5,773**

Note: Totals may not add due to rounding.

This baseline reflects some disturbing trends. The general fund deficit rises with only a brief interruption toward $400 billion. Because of growing Social Security surpluses, the total deficit stabilizes around $200 billion. Total debt, reflecting the general fund deficits, crosses the $5 trillion threshold late in 1995. In consequence, interest costs are projected to become the largest item in the general fund budget by 1992, when they will exceed defense spending for the first time, as seen in figure 2.13.

Figure 2.13: Gross Interest vs. Defense Outlays (1960-1997)



The budget summit negotiations that were in process as this report was being prepared for publication may lead to actions that would materially affect the baseline. In view of the uncertainty surrounding those negotiations, however, we have not reflected their possible outcome in the baseline.

Limitations of the Baseline

A baseline is only an extrapolation of current policies and funding levels into the future. These projections are developed according to the very specific estimating procedures embodied in the GRH deficit reduction legislation (the Balanced Budget and Emergency Deficit Control Act of 1985, as amended). Those procedures minimize the use of judgmental factors in estimating the deficit for purposes of implementing that legislation. One by-product of those procedures, however, is that known, unavoidable costs which were not funded in the base year, or for which legislation financing future spending has not been enacted, are usually excluded from the projections, potentially causing a misleading result.

As a result, the adjusted baseline is not an estimate of future spending and revenue levels. Policies, priorities, and funding levels change from year to year, but in ways that are difficult to predict. Thus, our baseline

does not include all the cost items that some might wish or expect to see covered in future budgets, such as a more aggressive attack on AIDS, homelessness, poverty among children, or the inadequacies of the nation's educational systems. Providing funds for new initiatives such as these within the baseline would require offsetting savings elsewhere.

Even more to the point, the baseline does not include funds for the many contingencies that will arise, including those about which the government has no choice but to pay the bills when they come due. A recent example of the potentially misleading nature of the baseline concept is the spending for RTC. As the cost of resolving the bankruptcy of the Federal Savings and Loan Insurance Corporation rose beyond the funding provided for that purpose, the official CBO baseline could not recognize that additional spending because of the limitations specified in the estimating procedures of the GRH legislation. But because that spending was clearly unavoidable if the government was to make good on the full faith and credit guarantee underlying the deposit insurance system, and because of the magnitude of the distortion in the estimates that would result from ignoring that spending, CBO made an adjustment in the baseline to reflect RTC spending from subsequent enactment of additional funding. But this "adjusted" CBO baseline has no official status for the GRH procedure until the additional funding is enacted.

We have concluded that there are other unavoidable costs that, because of the required estimating procedures, have not been recognized in the baseline. These include, for example, the cost of cleaning up and modernizing the nation's nuclear weapons complex. Another example involves the Medicaid program. Recent court decisions raise the possibility that states will be forced to increase the fees they pay to those providing services to Medicaid recipients. The federal government pays a high percentage of those costs, so there is a significant potential for major increases in Medicaid outlays. An even more recent example can be seen in the additional costs of deploying and maintaining a large military force in the Middle East.

Furthermore, the baseline excludes the cost of many projects which have been approved, but for which actual construction funding has not yet been provided. Prominent examples include the Space Station and the Superconducting Super Collider. Consequently, terminating these programs would not represent a savings from the baseline (except for the early planning and design work currently being funded). Rather, it would prevent an increase in outlays and the deficit above the baseline. If any of these programs that are above the baseline, such as the Space

Station, are to be funded, they must not only compete with other programs above the baseline, such as cleaning up the nuclear weapons complex, they must also compete against programs within the baseline.

Budget Director Darman has recognized the threat posed by potentially costly items that are not reflected in budget estimates and baseline projections. In his introductory essay for the 1991 budget, he referred to them as "Hidden Pacmen," waiting to consume budget resources.

In summary, the baseline is only a starting point for assessing the budget outlook and for adjusting priorities within the budget. In view of the potential magnitude of the items that are not reflected in the baseline, it is an optimistic starting point.

In a report we issued in connection with the presidential and congressional transitions (The Budget Deficit, GAO/OCG-89-1TR, November 1988), we pointed out the budget threat posed by unrecognized costs, including those associated with the FSLIC insolvency. We remain very concerned about the potentially misleading nature of budget projections that fail to account for such threats and by the lack of systematic efforts to identify them, estimate their likely costs, and include them in official projections of the government's financial outlook. If the costs represented by these known and unknown (and sometimes unknowable) additions to outlays are not offset by savings in other programs or increased revenues, the deficit will be considerably higher than our baseline would imply.

We believe that better management, which is discussed at greater length in chapter 10, is critical to spotting future costs and in preventing them from developing. For example, better management can

- provide government with the ability to detect problems in their early stages and take corrective action before they become extremely costly; for example, there is no doubt that better management systems would have made it possible to deal with the savings and loan crisis at far less cost than is now the case; and
- prevent or minimize future costs through such measures as better administration of loan portfolios, improved procurement procedures, and proper maintenance of facilities.

Economic Policy Considerations

This chapter discusses the economic significance of large deficits and lays the economic policy foundation for deciding how much to reduce the deficit. Deficits matter primarily because they consume savings. Without adequate savings to finance investment, long-run economic growth suffers. In recent years, U.S. saving has been low compared both with historical norms and with other industrialized nations. This can be corrected by shifting the federal budget from deficit to surplus.

To restore domestic savings to levels more consistent with higher growth periods of the postwar era would require (all other things being equal) a budget surplus equal to about 2 percent of GNP. Accordingly, we conclude that a shift in fiscal policy of about $300 billion, to an overall budget surplus of about $180 billion (about 2 percent of GNP), phased in over several years, is a reasonable goal under the present circumstances. While there are potential risks for the economy in such a policy, the transition to an overall budget surplus can be managed successfully if it is

- phased in over a period of several years,
- backed by a credible plan and a strong political consensus, and
- supported by Federal Reserve action to facilitate lower interest rates.

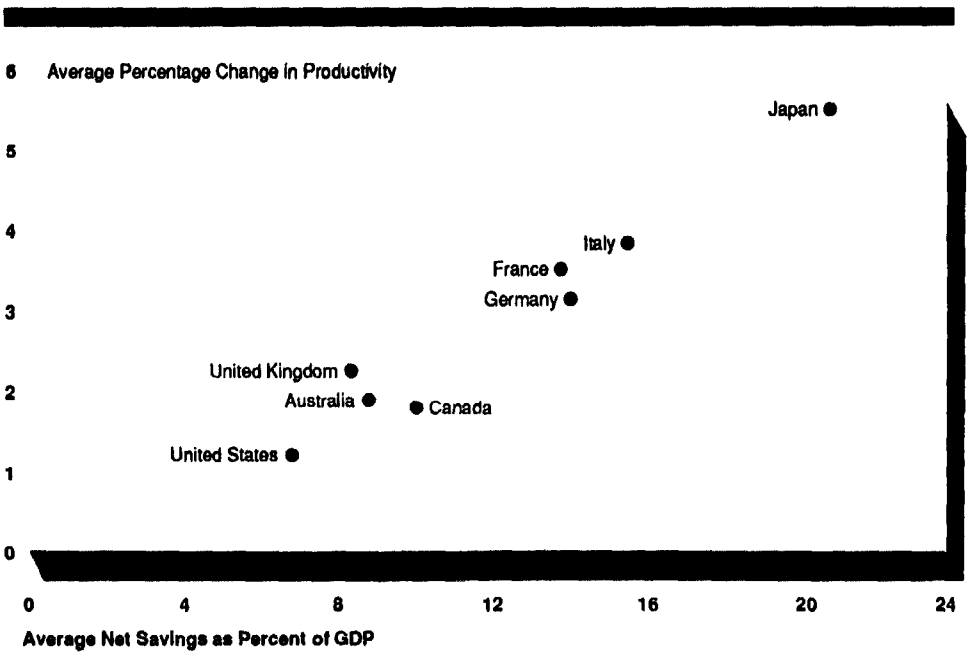
Opinion is currently divided about the likelihood that the U.S. economy is headed for a recession in the near future. In addition, there is concern that an oil price shock arising from conflict in the Middle East could increase risks for the U.S. economy. We believe that neither concern materially affects the fundamental issues we face. A major deficit reduction program should be undertaken as soon as possible in the manner just outlined. Under the circumstances, it is appropriate to be concerned about the timing of such a program, but it is vital that we deal with the deficit soon to avoid even more long-term damage to the economy.

As this report is being prepared for publication, in late August 1990, budget summit negotiations are about to resume. Published reports indicate that the negotiators are seeking to reach agreement on a deficit reduction package of $30 billion to $50 billion for 1991 and $500 billion over the 5-year period, 1991 to 1995. If these reports are accurate, the goals of the summit negotiations are considerably more modest than we believe necessary. Achieving them would be only a first step toward the more demanding goal that we recommend, based on the analysis in this chapter.

Why Deficits Matter

With the economy running close to full capacity, large and persistent budget deficits undermine the future well-being of the country by consuming savings that would otherwise be available to finance investment supporting long-term economic growth. Numerous studies, statistical indicators, and everyday observations all strongly suggest that America has not been saving and investing enough to achieve the related goals of assuring future living standards and preserving a degree of influence in the world adequate for the protection of our basic interests. Long-term improvements in living standards and other aspects of economic strength depend on growth in productivity. A nation will likely suffer diminished productivity growth if it saves too little and is unable to invest adequately. The international comparisons shown in figure 3.1 make this point dramatically; those who grow are those who save.

Figure 3.1: Countries With High Net Savings Experience High Productivity Growth (1960-1987)



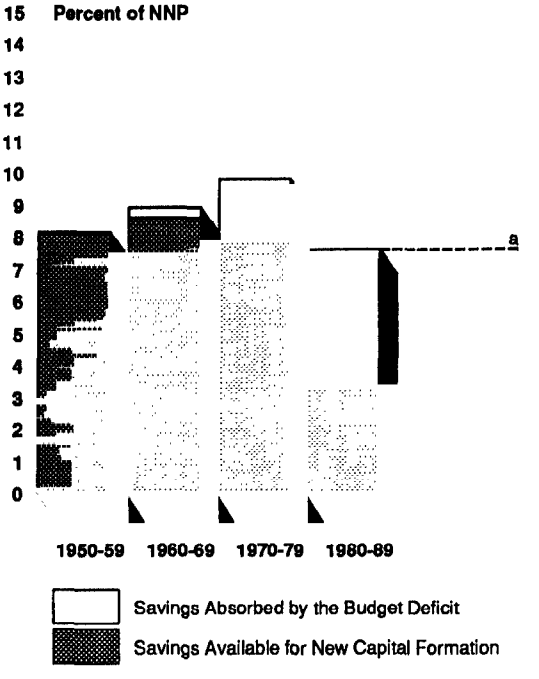
The effects of an investment shortfall are cumulative. An interruption of a few years in a generally high level of investment is no cause for alarm. But the implications for the future are increasingly ominous when, year after year, the nation

- skimps on investing in plant and equipment, education and training, and research and development;

- allows environmental hazards to accumulate by declining to invest in preventive measures;
- subjects highways, airports, and other public facilities to increasingly intensive use, but fails to make adequate provision for orderly maintenance and expansion; and
- finances a major proportion of its domestic investment by borrowing abroad and selling off assets to foreign investors.

The budget deficit is not the only reason for this underinvestment, but it has been a major contributor to the problem by absorbing between half and three-fourths of the net savings generated by the private sector and by the accumulating pension funds of state and local governments. Figure 3.2 displays the trend in net savings, recognizing that savings equal to depreciation is needed just to hold the total capital stock level. The federal deficit has absorbed half or more of the resources available to promote long-term growth.

Figure 3.2: Effect of the Federal Budget Deficit on Net Savings (1950-1989)



[a]Savings of households, net business savings, and state and local government surplus.

But that is only part of the story. If the increased federal deficit had been matched by increased individual savings, it would not have hurt investment. This is not what happened. The deficit's drain on savings has come at a time when net business saving and personal saving were markedly lower in relation to net national product (NNP) than in any previous decade since World War II. Thus, in the 1980s, the federal deficit became—for the first time—a major offset to saving, while at the same time saving in the rest of the economy was declining.

It would be desirable to increase private savings, but there is no federal policy that can have the reliable and direct impact on the business or personal component of savings that the federal budget deficit has on the total. The contribution of state and local government pension fund accumulations (the principal source of state and local surpluses) is relatively small and is unlikely to increase. In this context, the federal budget deficit takes on even greater importance in the national savings picture, precisely because saving trends in the other sectors are both unfavorable and less subject to policy control.

Historical Perspective on Investment

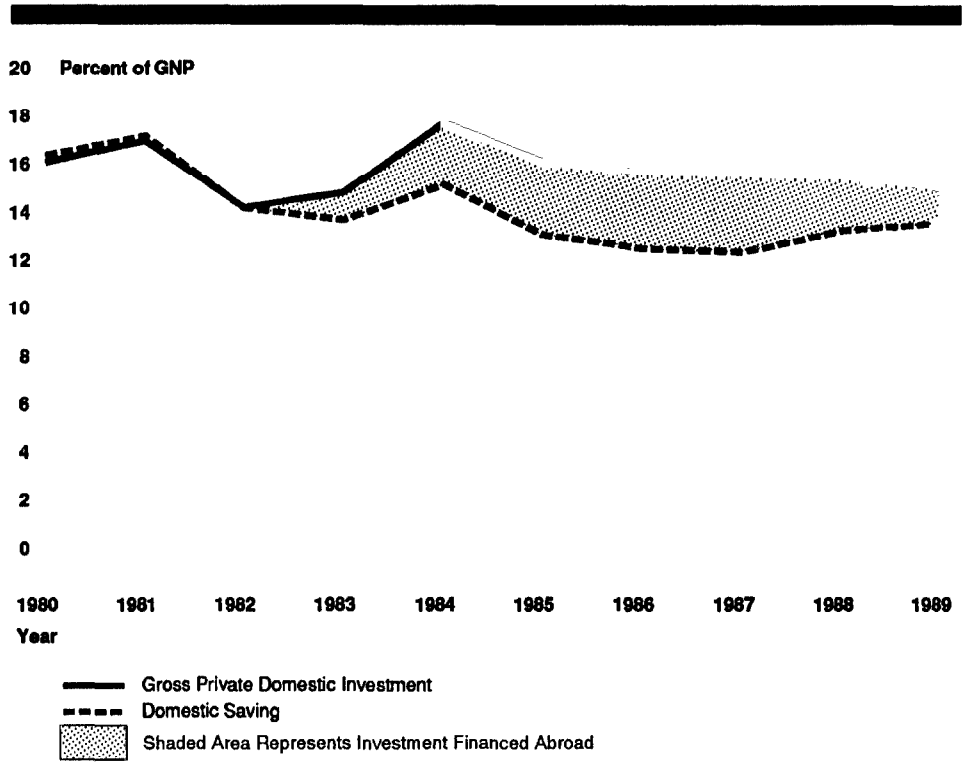
There is evidence of several types that the U.S. economy is suffering from a syndrome of low savings, consequent low investment, and resulting low rates of growth. This evidence is discussed in greater detail in appendix I of the companion volume to this report, GAO/OCG-90-5A, which places the economic events of the recent past in a wider historical perspective. In summary, not only has domestic investment been low relative to GNP in recent years, but much of that investment has been financed by foreign savings. In 1989, for example, fixed investment was the lowest share of GNP since 1975, and only slightly above the lowest share of any year in the entire period since World War II. But even this low level of investment was more than domestic savings alone would have permitted, and this has been true in every year since 1982. In 1986 and 1987, the difference was more than 25 percent. As an accounting matter, this difference corresponds to negative American investment abroad. That is, the portion of investment that could not be financed from U.S. savings was financed by

- foreign direct investment here,
- sale of U.S. assets (at home or abroad) to foreign investors, and
- borrowing abroad.

During the 1980s, the savings inflow represented by this negative U.S. net investment abroad permitted domestic investment to remain above

the level that domestic savings alone would have permitted, as seen in figure 3.3.

Figure 3.3: Gross Savings and Private Domestic Investment (1980-1989)

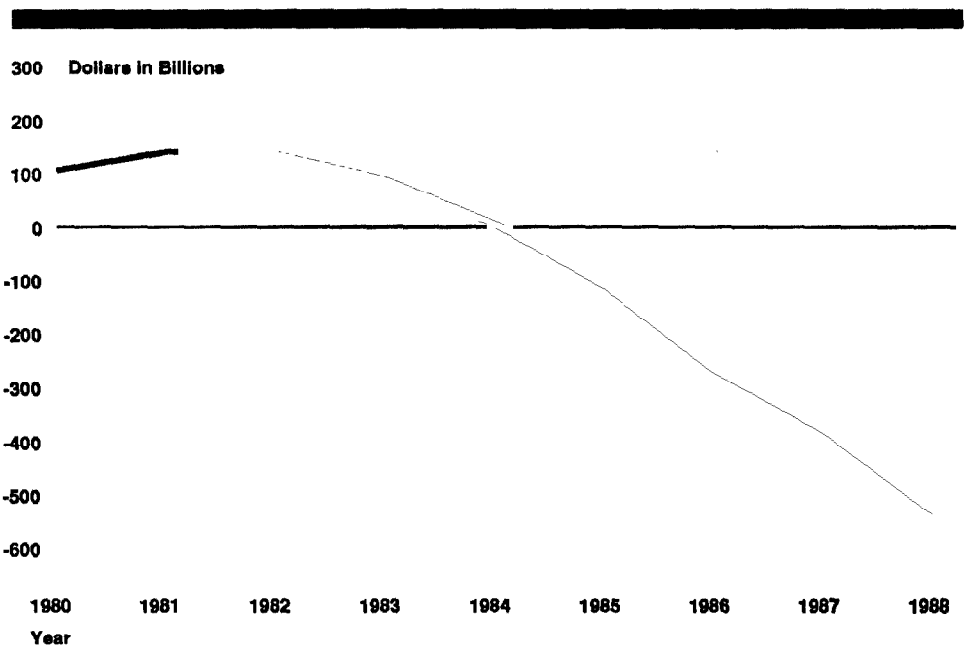


For the most part, the importation of foreign savings to finance our domestic investment reflected the fact that Americans bought more from the rest of the world than they sold there. To pay for the difference, we sold U.S. assets to foreign investors and borrowed from them. Given the poor saving performance of the American economy, it is fortunate that there are willing foreign buyers for the assets Americans wish to sell, and enthusiastic foreign investors to seize opportunities in the U.S. Without them, investment in the U.S. would have been lower, the growth of output would have been slower, and fewer jobs would have been created.

The willingness of foreign investors to invest here is a testimonial to American credit worthiness, but the increased reliance on foreign capital has obscured and postponed the consequences of the low domestic

saving rate. Our shift from being a major creditor to being the world's largest debtor nation has involved an enormous transfer of wealth from Americans to foreign investors. Because of that transfer of wealth, profits and interest payments will flow abroad in future years, depressing American living standards relative to what they would be if Americans owned those assets. We will probably not be able to continue borrowing and selling off assets abroad at the rate of recent years, because we have already dissipated our position as net creditor of the rest of the world and are running deeper into a net debtor position with every passing day, as can be seen in figure 3.4.

Figure 3.4: U.S. Net International Investment Position (1980-1988)



There are other grounds for concern about this dependence that are less easily quantified. The U.S. economy is vulnerable in a variety of ways to adverse economic and political developments abroad, influences transmitted either directly through economic channels or indirectly through political pressures that limit our freedom of action in economic policy. Part of this vulnerability is the price we pay for the many benefits that come from global economic interdependence. But part of the growing vulnerability reflects the economic choices that the United States has made, particularly the federal deficit. Because of its low total savings,

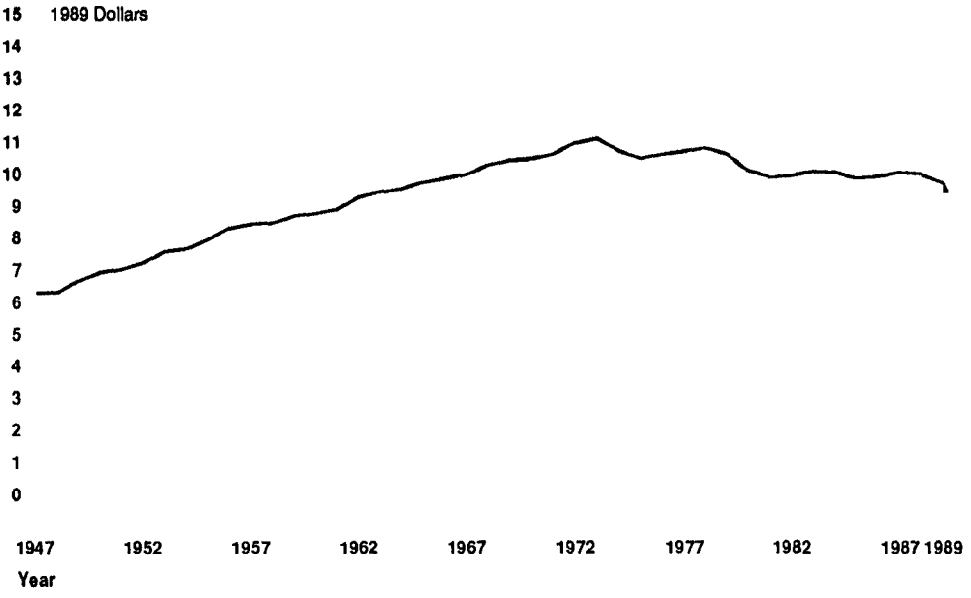
the United States has had to rely heavily on foreign savings and investment. Accordingly, it must be more sensitive to the needs and views of the foreign investors who finance our debt and who own the factories that generate new jobs.

It is sometimes said that the deficit will ultimately lead to a financial collapse and, conversely, that the absence of such a collapse is evidence that the deficit has no serious consequences. In fact, it is unlikely that the budget deficit by itself will produce a dramatic collapse. Continuing large deficits affect the economy seriously and fundamentally, but gradually. They have only limited potential for generating the discrete events that might trigger a collapse. However, the high real interest rates to which the deficit contributes are undeniably a source of strain. There is also the possibility that developments abroad might lead to a relatively abrupt disappearance of foreign investors from U.S. securities markets, such as the market for government securities. The resulting sharp rise in interest rates might precipitate a crisis. Thus, the deficit adds vulnerability to a financial and economic system that already has many other sources of vulnerability.

Real Wages

One consequence of lower domestic investment is that workers have less and older equipment with which to work. This means that productivity growth lags and wage increases may fail to keep up with inflation. Figure 3.5 shows that the peak in wages, adjusted for inflation, was reached in 1973. Toward the end of that year, the oil embargo ushered in the economic trouble of the 1970s. By 1989, real wages were below the level of 20 years earlier. Other data, using more comprehensive measures of compensation, portray only a slightly better picture.

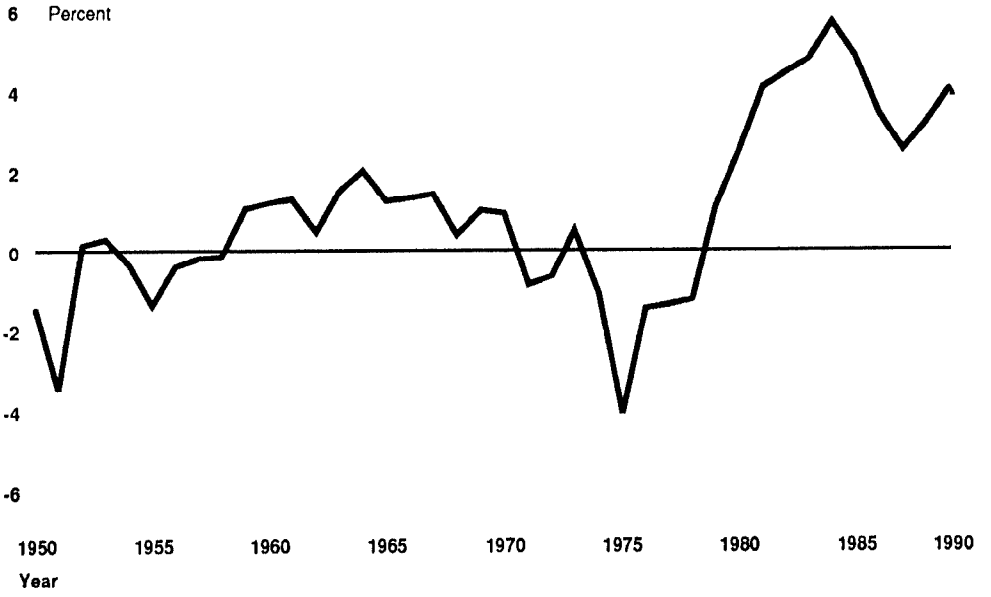
Figure 3.5: Average Hourly Earnings (1947-1989)



Real Interest Rates

In a market economy suffering from inadequate savings, high interest rates restrict investment to the level permitted by the available savings. Figure 3.6 shows the historical pattern of short-term real interest rates, defined as the rate on 3-month Treasury bills minus the rate of inflation. Here again, history confirms the effects of low saving rates. Real rates of interest were at historic highs in the mid-1980s. Both the low national saving rate and the persistence of inflationary expectations from the 1979 through 1982 period probably contributed to those high rates. Since 1985, there has been modest improvement in the overall saving rate and inflation has remained under control. Real rates have fallen significantly, but remain above historical norms.

Figure 3.6: Real Short-Term Interest Rates (1950-1990)



In sum, the official measures of saving and investment indicate that the past decade has been marked by a historically significant trend toward devoting a smaller share of current output to provision for the future. The results are evident in our deteriorating international investment position, high real interest rates, and low real wages. While some of these official statistics have shortcomings, there is no reason to question the general picture they paint. International comparisons corroborate that picture, consistently showing that the economies that have recently outperformed ours, especially the Japanese, devote much larger fractions of output to investment.

Setting Fiscal Policy Objectives

This section examines the economic considerations that are involved in choosing long-term budgetary objectives. We base our recommendation on the need to restore total domestic savings to levels more consistent with higher growth periods of the postwar era, and to do so at a pace that would not create undue risks for the economy. After examining the data, we have concluded that this objective requires a shift in fiscal policy of about $300 billion toward surplus, to be fully phased in by fiscal year 1997. If this were accomplished, the budgetary results in 1997 would be a total surplus of about $182 billion (as discussed in chapter 4), or about 2 percent of GNP.

Neither accounting principles nor economic analysis can demonstrate that any particular figure or schedule for reaching it are precisely correct. But we conclude that it is an appropriate and reasonable target under the present circumstances. A significantly less ambitious goal would not adequately serve the nation's needs. An even more ambitious goal would probably further accelerate the long-term growth of the economy, leading to higher future standards of living and even greater influence in world affairs. In our view, the risk is that we will do too little, not too much.

Analysis of the $300 Billion Goal

As a first step toward placing the proposed fiscal policy shift in perspective, we examined what it would have meant if an equivalent shift in real terms had already been accomplished by 1989. It would have been enough to halt the deterioration in the net international investment position of the United States, though at a level more than half a trillion dollars below the dead-even position of only 5 years previously. Gross savings and fixed investment would rise significantly, but not to historically unprecedented levels.

This suggests that our proposal is a reasonable starting point, but it is too simplistic to be adequately reassuring by itself. The fiscal policy shift would cause other adjustments in economic behavior; the real economy will not just stand still while major adjustments occur in a few savings and investment accounts. Furthermore, the fact that the change would be phased in gradually means that, as the last step was taken, the economy would be substantially changed. For example, the public debt will continue to rise, even as the deficit begins to fall, and the net international investment position will continue to deteriorate for years, even as the trade balance improves. Thus a more sophisticated analysis is needed to assess the implications of our proposal.

Analysis Using Macroeconomic Techniques

We examined the effects of our deficit reduction recommendation using macroeconomic forecasting techniques. The results of these simulations are discussed in greater detail in appendix I of the companion volume to this report, GAO/OCG-90-5A. In summary, they support the conclusion that an aggressive attack on the deficit

- does not seriously imperil continued economic growth in the short term;
- is likely to cause some temporary increase in unemployment;
- will yield lower interest rates, strengthened investment, and higher exports; and

- will generate a significantly higher rate of long-term economic growth by the turn of the century.

The simulations show no sign that the postulated shift in fiscal policy would produce a recession. The simulations also support the conclusion that the effects on the economy do not change materially with different mixes of spending cuts and revenue increases.

We considered carefully the plausibility of these simulation results. The degree of confidence to be placed in them is a key issue. Some argue that, because the economy is currently somewhat sluggish, now is not the time to attack the deficit. However, we conclude that the encouraging results of the simulations can be accepted with reasonably high confidence, provided that

- the fiscal policy shift occurs over a period of several years,
- a credible deficit reduction plan is backed by a strong political consensus, and
- the Federal Reserve responds by facilitating lower interest rates.

Most of the analysis leading to these conclusions was performed before Iraq's invasion of Kuwait. Limited reanalysis suggests that price increases resulting from loss of Iraqi and Kuwaiti oil will probably reduce U.S. economic growth slightly in the near term, but this is largely independent of whether or not we undertake a deficit reduction program. Such a program, if undertaken in the fashion outlined above, need not materially increase the risks to the economy created by the current turmoil in the Middle East. However, the economy is currently showing some signs of softness and any weakness could be worsened by problems of energy supply. Nevertheless, we believe it is appropriate to begin action now. As will be seen in subsequent chapters of this report, the policy changes required to achieve the needed shift in fiscal policy are difficult, involving major, time-consuming legislative actions. Because the long-term damage to the economy from the deficit is cumulative, any delay only increases the problem. Thus, it is important to begin action promptly so that there can be assurance of major progress on the deficit as soon as possible. That is the premise on which we have based the deficit reduction strategies and choices set forth in the subsequent chapters of this report.

Framework for Deficit Reduction

In chapter 3, we recommended a $300 billion shift in fiscal policy to be achieved by 1997. But deciding on the total amount of deficit reduction to be pursued is only the start. This chapter provides a planning framework for deciding how to achieve that target. We review the arithmetic of deficit reduction, stressing the reduction in debt service costs that follows from policy changes to reduce the deficit. We then outline the range of choices for policy actions that could achieve the needed change in fiscal policy. Several possible combinations of defense and domestic spending reductions and revenue increases are then discussed, illustrating the implications of choosing one approach rather than another. These illustrations are supported by the expanded discussion of each area in the subsequent chapters.

As this report is being prepared for publication, in late August 1990, budget summit negotiations are about to resume. In chapter 3, we explained why we believe the reported goals of those negotiations are insufficient to meet the needs of the nation for increased saving, investment, and long-term growth. Accordingly, we recommend that as the first order of business of the 102nd Congress (or sooner, if possible) negotiations resume with the objectives of

- reaching agreement on a comprehensive package of policy changes that will produce an overall budget surplus of about 2 percent of GNP (about $180 billion) by 1997 and
- enacting those changes into law in the form of a multiyear budget resolution, along with the substantive legislation required to implement that resolution, by the conclusion of the First Session of the 102nd Congress.

This chapter, together with chapters 5 through 7, provides a basis for examining the choices that must be made in developing that package of policy changes.

Overall Arithmetic of Deficit Reduction

Any reduction in the deficit will be comprised of cuts in programs, increases in receipts, and the interest savings that result from financing a smaller volume of debt. The $50 billion annual target indicated by the analysis in chapter 3 would require program cuts or revenue increases averaging about $40 billion annually from 1992 to 1997, with the remaining $10 billion coming from reduced debt service charges. In 1997, the total policy change from the baseline would need to be about $240 billion, yielding a further $60 billion in debt service savings. These two amounts, taken together, represent the direct effects of a deficit reduction program. Because this portion of the program is under the

direct control of the government, we call the total amount ($300 billion) the "fiscal policy shift." This shift, and the actions needed to achieve it, are the primary focus of the remainder of the report.

However, a credible attack on the structural deficit of this magnitude could yield a "bonus" in the form of reduced interest rates. This would further reduce debt service costs in 1997 by as much as another $60 billion. Because these savings depend on the response of the financial markets, which would be influenced by the policies of the Federal Reserve System, we call it the "interest rate bonus." But these savings may be smaller than we now project if the financial markets are skeptical about the government's commitment to deficit reduction. Furthermore, with the growing integration of U.S. and foreign financial markets, interest rates here are much more influenced by developments abroad than in past eras. The growing demand for capital elsewhere, such as to meet the needs for reconstruction in Eastern Europe, could well presage a worldwide secular rise in interest rates, from which the United States would not be immune.

This arithmetic, showing the two components of the fiscal policy shift, plus the monetary policy "bonus," is displayed in table 4.1.

Table 4.1: The Arithmetic of Deficit Reduction for 1992 Through 1997

Dollars in billions

	1992	1993	1994	1995	1996	1997	Total
Adjusted baseline							
Total deficit	$−251	$−217	$−181	$−185	$−186	$−180	
Changes:							
Fiscal policy shift:							
Policy changes	48	93	135	173	209	242	**900**
Debt service savings from policy change	2	7	15	27	41	58	**150**
Total fiscal policy shift	**50**	**100**	**150**	**200**	**250**	**300**	**1,050**
Interest rate "bonus"	12	22	35	48	55	62	**234**
Total change from baseline	62	122	185	248	305	362	**1,284**
Baseline after policy change							
Total Surplus or Deficit	**$−189**	**$−95**	**$4**	**$63**	**$118**	**$182**	

Note: Totals may not add due to rounding.

Illustrative Strategies

The harsh reality is that $240 billion in policy changes over a period of 6 years is a politically demanding target. It is clearly achievable, as the successful experience in making dramatic changes in budget policy in other democratic nations such as Australia demonstrates. But as our own experience over the past decade also demonstrates, assembling a package of policy changes that is politically acceptable and sustainable will be very difficult.

As a framework for examining the choices that must be faced if a large deficit reduction program is to be implemented, we postulated a wide array of basic approaches, involving various combinations of defense and domestic spending reductions and revenue increases. These are displayed in table 4.2.

Table 4.2: Basic Choices for Deficit Reduction (Changes From the 1997 Baseline)

Dollars in billions

Policy sets	Policy changes			Total policy change	Debt service savings	Total fiscal policy shift
	Defense	Nondefense	Revenues			
Set 1	$70	$85	$85	$240	$60	$300
	70	60	110	240	60	300
	70	110	60	240	60	300
	70	170	0	240	60	300
	70	0	170	240	60	300
Set 2	100	70	70	240	60	300
	100	50	90	240	60	300
	100	90	50	240	60	300
	100	140	0	240	60	300
	100	0	140	240	60	300
Set 3	120	60	60	240	60	300
	120	45	75	240	60	300
	120	75	45	240	60	300
	120	120	0	240	60	300
	120	0	120	240	60	300

These basic alternatives only begin to illustrate the possible combinations of spending reductions and revenue increases that could yield the needed shift in fiscal policy. However, this list brackets the range of choices and provides a framework for the further development of those choices in subsequent chapters of the report.

In each case, we assumed that there would be some significant defense spending reductions below the baseline. The debate in the summer of 1990 was not on whether to cut back in this area, but rather on how to balance the need to deal with new problems, such as those in the Middle East, with the declining threat from the Soviet Union and Eastern Europe. We postulated long-run defense reductions below the 1997 baseline of $70 billion, $100 billion, or $120 billion. The balance of the required total policy change was then allocated in varying combinations of lower nondefense spending or additional revenue.

Illustrative Packages

The Congress has already cut the deficit where there is a broad consensus for eliminating programs because of their intrinsic defects or for increasing taxes because of their intrinsic merits. The process of deficit reduction requires a new consensus, one that supports a package of

policy changes that is seen as fair and that considers the interest of future generations of Americans.

The following discussion of the implications of various combinations is intended to illustrate the tradeoffs that must be faced in developing a politically acceptable package. It also demonstrates the consequences of refusing to consider all the possible sources of deficit reduction as part of a comprehensive program.

Table 4.3: $70 Billion Defense Restructuring—No New Revenues (Package 1)

Dollars in billions

Category	Amount
Defense Savings	$70
Nondefense Savings	170
Revenue Increases	0

This package demonstrates the consequences of seeking to reach the fiscal policy target without additional revenue and with modest savings in defense, such as the 25 percent reduction in the force structure reflected in the Department of Defense (DOD) illustrative package presented to the budget summit negotiators. The required savings from domestic programs would still provide the resources to support core functions, such as revenue collection and law enforcement, and would finance most low income support programs. Other activities would have to be eliminated unless they could be financed from user charges or other dedicated receipts. Medicare, for example, would have to be financed by increases in monthly premiums or a substantial curtailment of services or of fees paid to providers.

Table 4.4: $120 Billion Defense Restructuring—No Domestic Cuts (Package 2)

Dollars in billions

Category	Amount
Defense Savings	$120
Nondefense Savings	0
Revenue Increase	120

This package illustrates the consequences of seeking to achieve the fiscal policy target entirely through defense cuts and revenue increases without reducing the current role of the federal government in domestic programs. For defense (as discussed in chapter 5), it would entail as much as a 50 percent reduction in the military force structure, if the

cuts were distributed in the same general fashion as those in DOD's illustrative force structure reduction.

To raise $120 billion in revenue from any single source would require substantial changes in the current tax system including large rate increases, or major base broadening measures, or the introduction of a value-added or national retail sales tax. A blended approach would be preferable. Many combinations are possible, but one might be an income tax approach that combines rate increases and base broadeners. Another might be a consumption tax approach that includes excise tax increases and adjustments to the income tax to offset regressivity.

Lower defense cuts in this package would require even more revenue. For example, if the defense savings were constrained to $70 billion, while still maintaining the nondefense portion of the budget, $170 billion in additional revenue would need to be raised. The analysis in chapter 7 shows that raising $170 billion from any single revenue source would require a very substantial departure from the current system. For example, income tax rates would have to be raised from the current 15, 28, and 33 percent levels to 18, 34, and 40 percent, or entire categories of tax deductions or exempt income would have to be eliminated. Raising $170 billion from consumption taxes would require a value-added tax or a national retail sales tax. Accordingly, a mixed approach would seem more realistic.

Table 4.5: Proportional Cuts (Package 3)

Dollars in billions

Category	Amount
Defense Savings	$70
Nondefense Savings	85
Revenue Increases	85

This package shows the implications of allocating the burden of deficit reduction in proportional shares among defense cuts, nondefense cuts, and revenue increases. Important policy changes would be required in each area. In defense, this package implies approximately a 25 percent reduction in the force structure if distributed in the same general fashion as that illustrated by DOD. In nondefense programs, funding for popular programs would have to be reduced substantially or eliminated, others would have to be funded through user fees, and some functions would probably have to be devolved to the States with substantially reduced federal funding.

There are a number of ways to raise the needed $85 billion in additional revenue. One approach would be to combine increased excise taxes with broadening the income tax base and increasing rates slightly. If the excise taxes included a dramatic increase in the gasoline tax or the imposition of a new, broad-based energy tax, increases in income tax rates might be avoided but base broadeners would still be needed. Although the entire $85 billion could be raised through a value-added tax (VAT), it would hardly be worth the setup, administrative, and enforcement costs for this level of additional revenue.

Table 4.6: $50 Billion in Domestic Cuts—Equal Shares From Defense and Revenues (Package 4)

Dollars in billions

Category	Amount
Defense Savings	$100
Nondefense Savings	50
Revenue Increases	90

This package illustrates the effects of limiting the nondefense program cuts and achieving the deficit reduction primarily in defense savings and revenue increases. The defense savings would require about a one-third reduction in the force structure if distributed in the fashion suggested by DOD's illustrative program. Other approaches could achieve the same result. For example, it might be possible to eliminate selected weapons systems and otherwise slow the pace of modernization and reduce the cost of supporting functions such as the Defense Logistics Agency and the portion of the military hospital system located in the U.S. These would allow the needed savings to be achieved with somewhat smaller force structure reductions.

Raising the needed revenues for this package would involve the same considerations as package 3.

While the postulated nondefense savings in this package are somewhat more modest than in the others, they would still entail a significant departure from current priorities. Some activities could be maintained by financing them with user fees. A comprehensive program of user fees, applying commonly accepted principles of public finance, might provide $18 billion of the savings. The remaining $32 billion would have to come from the reduction or elimination of programs.

Table 4.7: $120 Billion Defense Restructuring—Equal Shares From Nondefense and Revenues (Package 5)

Dollars in billions

Category	Amount
Defense Savings	$120
Nondefense Savings	60
Revenue Increases	60

This package illustrates the potential easing of the burden on nondefense programs and revenues that would accompany a substantial reduction in the cost of the military establishment. As noted previously, this level of defense cut could require a force structure reduction of up to 50 percent. As is discussed in chapter 5, however, this might not be the most appropriate way of achieving the reductions. Whatever the budget resources that can be made available for defense, they should be used to build a force that most effectively meets the security needs of the nation. That might imply a very different set of military priorities, force structure, and approach to modernization than was suited to the international situation of the past.

The nondefense savings could start with a comprehensive program of user charges, but this would fall well short of what is needed. The remainder would have to come from the reduction or elimination of programs.

Raising $60 billion in revenues could be accomplished in numerous ways: rate increases alone, eliminating a few "loopholes" completely or limiting more of them, substantial increases in excise taxes, or any combination of these approaches.

These illustrative packages of policy changes are intended only to demonstrate the choices that must be made and the extent to which those choices are driven by the allocation of the deficit reduction burden among the major components of the budget. The implications for particular programs are discussed in greater detail in chapters 5 and 6, and for revenues in chapter 7.

Defense Alternatives

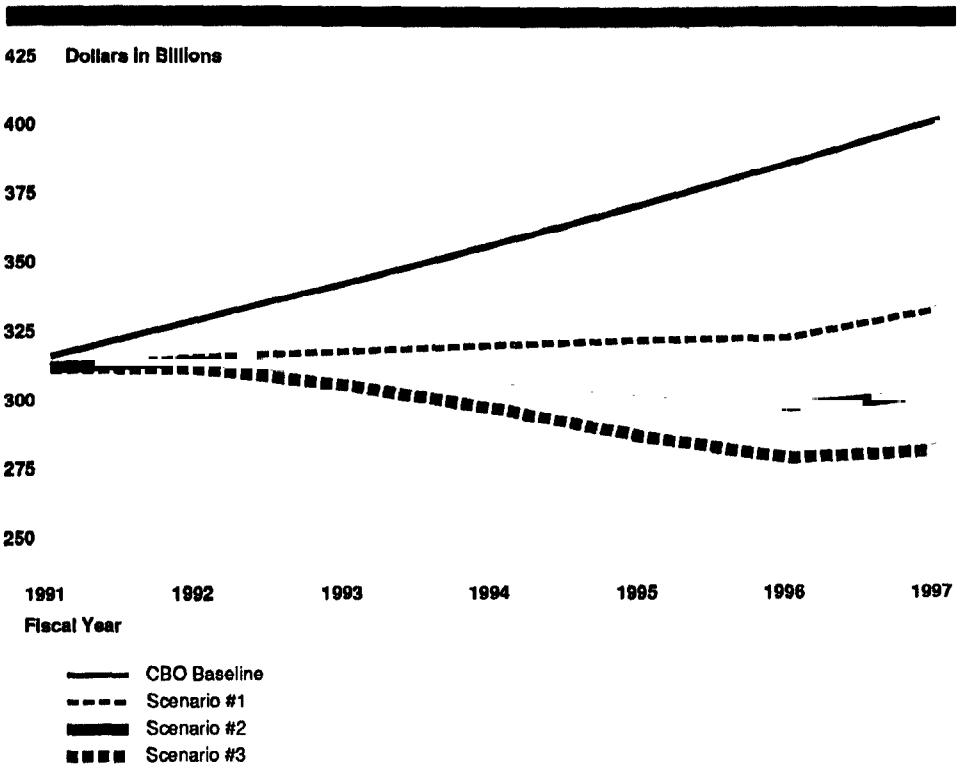
Since shortly after the end of World War II, the U.S. defense budget has been driven overwhelmingly by the need to counter the military threat from the Soviet Union. This has entailed maintaining a peacetime military establishment which is extraordinarily large by historical standards. This military force structure has been built around the principal mission of deterring both strategic nuclear war and large scale conventional war in Central Europe. Recent events in Eastern Europe and the Soviet Union permit a major reexamination of the defense posture of the nation and the budgetary resources required to support the defense establishment.

The current U.S. military involvement in the Middle East makes it difficult to focus attention on the comprehensive reassessment of the force structure that is needed to adapt that structure to the post-Cold War era. Nevertheless, that reexamination is essential and should be undertaken as soon as circumstances permit.

The need to reduce the budget deficit lends added urgency to such a reexamination. The defense budget is such a dominant part of the overall federal budget, and particularly of the general fund where the structural imbalance is centered, that constraints on defense spending must inevitably be part of any aggressive attack on the deficit.

The profiles of deficit reduction strategies outlined in chapter 4 involve defense budget reductions below the 1997 baseline of approximately $70 billion, $100 billion, or $120 billion. This chapter illustrates choices that might be made to achieve savings of those magnitudes which are shown in Figure 5.1. We emphasize that the purpose of this part of the report is to illustrate the implications of what might be required to achieve major reductions in the deficit.

Figure 5.1: Alternative Defense Budget Levels (1991-1997)



Alternative Approaches to Restructuring

The inclusion of particular items in an option does not imply that we endorse that specific item or the level of spending reduction in that option. Indeed, the options illustrated in this chapter all involve reductions that are spread in a relatively uniform fashion across the force structure. Thus, they all yield a force structure that looks much like the one existing today, but smaller. In developing a new force structure for the post-cold war era, however, proportional cuts in all parts of the force structure may not be the appropriate course of action. The new force structure should be built around a careful assessment of the likely future threats to our national security and vital interests and of the circumstances in which the nation may need the capacity to apply military force.

Approaching the task from this perspective, rather than as a matter of simply downsizing the present forces, might lead to a new structure that is very different from any of those to be illustrated here. Also, while an overall reduction in the defense budget would occur, there could be increases in some parts of the budget. One approach, for example, might

start with the assumption that the principal threat facing the United States in the future is not a large scale conventional or nuclear conflict that emerges with little warning, but rather threats to U.S. economic interests and citizens in remote areas of the world, involving the application of relatively low intensity military force. An option structured around this thinking might make disproportionate reductions in forces built to counter the previous Soviet threat of nuclear attack or of conventional attack in Central Europe, while protecting forces that are relatively more mobile and readily deployed to remote areas.

Another alternative might involve a fundamentally different approach to modernization. For example, many new weapons systems might be stopped after the research, development, and prototype stages. This would ensure that the United States retained the capacity to produce the most technologically advanced weapons, but the actual production and fielding of new generations of weapons would take place at much longer intervals than has been the pattern in the recent past. This approach would also ensure that any new generation of weapons would be thoroughly tested in the prototype stage before a decision was made to begin production. Systems currently in development or procurement that might be considered for termination or reduction are listed in table 5.8 appearing at the end of this chapter. Some of these are likely, of course, to have been subject to reductions in association with the force structure reductions under the illustrative options, so that the savings available for realization under this option may be less than is indicated if this approach is combined with one of those options.

Another approach might involve even deeper reductions in fully-staffed active units than those proposed in the option discussed below. Those retained would be maintained at a high state of readiness and coupled with substantially greater investment in airlift and relatively high-speed sealift capacity. This could significantly increase U.S. capability to respond with effective military force in remote locations. Other units might be retained in "cadre" status, ready for augmentation if threats emerge that would require mobilization for large scale conventional warfare.

In summary, the choices to be made in moving toward a smaller defense establishment must depend heavily on judgments about the future threats facing the United States and upon the circumstances in which the nation may wish to be capable of applying military force, balanced against the portion of the nation's economic capacity it is prepared to devote to the military establishment.

Summary of Options

With this perspective, our three illustrative options are discussed.

Option 1

The $70 billion option was developed by pricing out an illustrative 25 percent force structure reduction set out by the Secretary of Defense, but using notional unit costs estimated by us, rather than the appropriation account estimates supplied by DOD. Our methodology for developing the notional unit costs is discussed in appendix II of GAO/OCG-90-5A. Our estimates were reviewed by DOD officials, who agreed with the logic of the approach, but have not endorsed the specific estimates.

Option 2

The $100 billion option was developed by identifying additional force structure reductions that would be consistent with a more aggressive application of the approach embodied in the Secretary's illustrative package.

Option 3

The most severe option is a reduction of $120 billion from the 1997 baseline. It would entail a further extension of the force structure reduction reflected in the DOD illustration and in options 1 and 2.

DOD's 25 Percent Illustrative Force Reduction

At the request of those engaged in the budget summit negotiations, the Secretary of Defense estimated the budget effects of an illustrative 25-percent force structure reduction. The DOD material accompanying the Secretary's illustrative force reduction identified the forces that would be eliminated in terms of numbers of Air Force wings, Navy ships, and Army divisions. The resulting budget reductions were expressed on the basis of appropriation accounts, such as military personnel and procurement. The DOD material does not provide a clear explanation of how the force reductions were translated into budget reductions. As can be seen in table 5.1, the approach used by DOD resulted in a disproportionate reduction in funds for military personnel as compared to other components of the DOD budget. Military personnel, making up about 27 percent of the DOD budget, accounted for 48 percent of the presumed savings.

Table 5.1: Relationship Between Funds Available and Illustrative Budget Reductions in 1995

Percent of total[a]		
Appropriation accounts	**CBO baseline**	**DOD reduction**
Military personnel	27	48
Operations and maintenance	30	25
Procurement	26	26
Research, development, test, and evaluation	12	0
Military construction	2	1
Family housing	1	1
Other national defense	3	0

[a]Does not add to 100 due to rounding.
Source: Calculated from DOD illustrative budget data.

The DOD illustrative force structure reduction maintained on a proportional basis the current mix between active and reserve personnel. This is an important consideration for the budget because active forces are much more expensive than equivalent reserve units. For example, an active division or air wing costs three times as much as an equivalent reserve unit. Table 5.2 shows how DOD distributed the illustrative force reductions.

Table 5.2: DOD Illustrative Force Structure Reductions

Service	FY 1990 level	DOD reduction	FY 1995 level
General purpose forces			
Army divisions	18	6	12
Navy			
Ships	530	100	430
Carrier battle groups	14	2	12
Marine brigades	9	1	8
Air force tactical wings	24	9	15
Strategic forces			
Navy ships (SSBN)	36	11	25
Air Force wings	27	4.7	22.3
Reserves			
Army divisions	10	4	6
Navy	153.8[a]	2.5[a]	151.3[a]
Air Force wings	50	3.3	46.7

Legend SSBN = ballistic missile submarine
[a]Persons in thousands.
Source: DOD illustrative budget data and other DOD information.

DOD estimates that the 25 percent force structure reduction results in a budget reduction of $39.8 billion or 11 percent from the fiscal year 1995 CBO baseline. As discussed in previous chapters, we concluded that 1997 is a more appropriate point at which to plan on achieving the fiscal policy goal suggested in chapter 3. Therefore, we extended the budget effect of DOD's illustrative force reductions to 1997, at which point it yields a $55.8 billion, or 14 percent, reduction from the baseline.

Option 1—$70 Billion Reduction

This alternative involves repricing the DOD illustrative force structure reduction using notional unit cost estimates that we developed. These estimates spread most overhead, procurement, and support costs proportionally among forces. This assumes that costs will be reduced in proportion to any reduction in force structure. The development of these notional unit costs is discussed in detail in appendix II of GAO/OCG-90-5A. Applying these notional unit cost estimates to the force structure reductions in the DOD illustrative package would yield savings of $68.9 billion or 17 percent from the 1997 baseline for defense spending. These results are displayed in table 5.3.

Table 5.3: Option 1—$70 Billion Reduction

Dollars in billions

General purpose forces	Unit costs	1990 base force structure	Unit reduction	Resulting structure	Percent reduction from base structure	Savings from base-line
Army division	$3.94	18	6	12	33	$23.64
Navy						
Ships	0.16	530	100	430	19	
Carrier battle groups	6.14	14	2	12	14	16.00
Marine brigades	1.17	9	1	8	11	1.17
Air Force tactical wings	1.82	24	9	15	38	16.38
Strategic forces						
Navy ships (SSBN)	0.28	36	11	25	31	3.08
Air Force wings	0.72	27	5	22	19	3.60
Reserve forces						
Army division	1.13	10	4	6	40	4.52
Navy	0.03	154[a]	3	151[a]	2	0.09
Air Force wings	0.13	50	3	47	6	0.39
DOD-wide agencies	$32.40	$32.40			0	
Total savings in 1997						**$68.87**

[a]Persons in thousands.

Option 2—$100 Billion Reduction

This alternative carries the approach embodied in the DOD illustrative force structure reduction one step further by eliminating additional forces beyond those reflected in the DOD illustration, as shown in table 5.4. This option results in a 25 percent budget reduction from the 1997 CBO baseline.

Table 5.4: Additional Reductions Under Option 2

Dollars in billions

Additional reductions	Estimated additional savings
2 active Army divisions	$7.9
2 Navy carrier battle groups	12.3
2 Marine brigades	2.3
25 percent reduction in DOD-wide agencies	8.1
Total additional savings in 1997	**$30.6**

In addition to further reductions in forces, this option would include a 25 percent reduction in funding for DOD-wide agencies, such as the Defense Logistics Agency, which had been protected under the original DOD illustrative package. We believe that a 25 percent reduction in these activities would be a reasonable component of this option in light of the reduced force levels and the correspondingly reduced support needs. The force structure that would remain if this option were selected, along with the savings associated with the specific reductions, is shown in table 5.5.

Table 5.5: Option 2—$100 Billion Reduction

Dollars in billions

General purpose forces	Unit costs	1990 base force structure	Unit reduction	Resulting structure	Percent reduction from base structure	Savings from baseline
Army division	$3.94	18	8	10	44	$31.52
Navy						
Ships	0.16	530	130	400	25	
Carrier battle groups	6.14	14	4	10	29	28.28
Marine brigades	1.17	9	3	6	33	3.51
Air Force tactical wings	1.82	24	9	15	38	16.38
Strategic forces						
Navy ships (SSBN)	0.28	36	11	25	31	3.08
Air Force wings	0.72	27	5	22	19	3.60
Reserve Forces						
Army division	1.13	10	4	6	40	4.52
Navy	0.03	154[a]	3	151[a]	2	0.09
Air Force wings	0.13	50	3	47	6	0.39
DOD-wide agencies	$32.40	$32.40	$8.1	$24.3	25	8.10
Total savings in 1997						**$99.47[b]**

[a]Persons in thousands.

[b]Totals may not add due to rounding.

Option 3—$120 Billion Reduction

This alternative would involve a further extension of the approach embodied in the DOD illustrative package. Further reductions would be made in most of the active forces, and there would be a further reduction in funding for the DOD-wide agencies. The additional reductions, beyond those reflected in option 2, are set forth in table 5.6.

Table 5.6: Additional Reductions Under Option 3

Dollars in billions

Additional reductions	Estimated additional savings
1 active Army division	$3.9
2 Navy carrier battle groups	12.3
1 Air Force tactical wing	1.8
7% reduction in DOD-wide agencies	2.3
Total additional savings in 1997	**$20.3**

The force structure that would remain after implementation of this option is set forth in table 5.7.

Table 5.7: Option 3— $120 Billion Reduction

Dollars in billions

General purpose forces	Unit costs	1990 base force structure	Unit reduction	Resulting structure	Percent reduction from base structure	Savings from base-line
Army division	$3.94	18	9	9	50	$35.46
Navy						
Ships	0.16	530	160	370	30	
Carrier battle groups	6.14	14	6	8	40	40.56
Marine brigades	1.17	9	3	6	33	3.51
Air Force tactical wings	1.82	24	10	14	42	18.20
Strategic forces						
Navy ships (SSBN)	0.28	36	11	15	31	3.08
Air Force wings	0.72	27	5	22	29	3.60
Reserve forces						
Army division	1.13	10	4	6	40	4.52
Navy	0.03	154[a]	25	129[a]	16	0.75
Air Force wings	0.13	50	3	47	6	0.39
DOD-wide agencies	$32.40	$32.40	$10.40	$24	32	10.40
Total savings in 1997						**$120.48[b]**

[a]Persons in thousands.

[b]Totals may not add due to rounding.

Table 5.8: Other Illustrative Defense Budget Reductions

Dollars in billions

Illustrative Terminations	1991	1997	Total 1991-1997
Army			
ATACMS	$0.2	$0.1	$1.4
Blackhawk helicopter	0.5	0.5	3.3
Hellfire missile	0.2	0.1	0.9
Light helicopter (R&D)	0.5	0.1	3.0
Navy			
Seawolf Submarine	3.5	5.1	17.7
Air Force			
AMRAAM	1.4	1.2	9.6
B-2 Bomber	2.6	2.7	35.0
C-17 Transport	1.0	4.9	23.7
MX (Peacekeeper) Missile	0.7	0.0	4.0
Rail garrison	1.9	0.0	4.8
Small (Midgetman) ICBM	0.2	[a]	[a]
Tacit rainbow missile	0.3	0.5	2.3
Joint and Other Systems			
Milstar satellite	1.1	Class	Class
National aerospace plane (R&D)	0.2	0.5	2.5
Illustrative Reductions			
Navy			
DDG-51 Destroyer (from 10 to 6 every 2 years)	$1.4	$0.0	$11.1
D-5 Strategic missile (Equip only 9 Tridents)	0	2.0	6.0
Air Force			
F-16 Fighter (From 150 to 72 per year)	1.5	1.1	10.1

(continued)

Illustrative Reductions	1991	1997	Total 1991-1997
Other			
Strategic defense initiative (hold at 1990 level)	0.9	8.9	37.1
Independent R&D	3.1	4.0	24.8
10 percent of all other procurement	7.4	9.1	55.5
Total potential savings	**$28.6**	**$40.8**	**$255.9[b]**

Legend
AMRAAM = advanced medium range air-to-air missile
ATACMS = Army tactical missile system
DDG = guided missile destroyer
ICBM = intercontinental ballistic missile
R&D = research and development

[a]DOD has not published budget data for later than fiscal year 1994.

[b]Totals may not add due to rounding.

Note: Amounts do not include termination costs.

Sources of reduction proposals: CBO, DOD, Defense Budget Task Force, and the House and Senate Armed Services Committees.

Source of data: Projected by GAO using selected acquisition reports where available—otherwise potential savings were estimated by GAO.

Nondefense Alternatives

Different budget restraint options imply different views about the proper role of the federal government. The traditions of incremental decisionmaking, the structure of the Congress, and the evolution of political coalitions have not encouraged a systematic approach to defining this role or to examining its effect on the budget. In the 45 years since the end of World War II, the response to problems at the federal level has been to create a large variety of federal programs with little explicit concern for balance and consistency. Indeed, not until the passage of the Congressional Budget Act of 1974 did the Congress even make its budget decisions in the context of a stated overall fiscal strategy.

Defining the Federal Role

The spending reductions presented in this chapter represent one approach to defining the role of the federal government in society more explicitly and reconciling that role to the fiscal realities of the 1990s. Four specific deficit reduction packages are used to illustrate ways to achieve the fiscal policy goals outlined in chapter 3. These options would involve domestic budget reductions below the 1997 baseline of $45 billion, $90 billion, $120 billion, and $170 billion. These four packages apply 10 major domestic spending cut strategies which are listed in table 6.2 later in this chapter.

Even the smallest reduction package would imply a significant change in federal domestic policy, going well beyond what the Congress as a whole has been able to support in the past. At the high end of the range, the federal role would change dramatically. Domestic expenditures would decline by about 15 percent; excluding Social Security, the reduction would be 22 percent.

As table 6.1 shows, Social Security, Medicare, and retirement and disability programs represent 59 percent of domestic program outlays, excluding interest costs. Accordingly, any major reduction in domestic spending cannot ignore these programs which represent by far the largest potential source of cuts.

Table 6.1: Distribution of Baseline Nondefense Program Outlays for 1997

Dollars in billions

	Amount	Percent
Nonmeans-tested entitlements		
Social Security	$370	32
Medicare	218	19
Federal retirement and disability benefits	94	8
Subtotal	$682	59
Means-tested entitlements (including Medicaid)	$175	15
Other nondefense programs	295	26
Total Nondefense Program Outlays	**$1,152**	**100**

Note: Amounts exclude defense and net interest outlays and proprietary receipts credited to receipt accounts.

Source: GAO estimates extrapolated from CBO baseline estimates

As one moves from the low end of the range of domestic cuts to the high end, the choices that can be exercised in defining the federal government's role in our society become increasingly limited. At the high end of the range, the effect would be to limit that role to certain core functions such as revenue collection, law enforcement and justice, and some low income support programs. The other remaining programs or activities would be largely limited to those that are financed with earmarked taxes or user fees.

One reason for these consequences is that we have rejected the option of using trust fund surpluses to mask the shortfall in revenue to support the general operations of government. This is not to imply that just because they are self-financed, trust fund activities are necessarily more meritorious. That is a separate issue. As stated in chapter 2, we believe that the fundamental problem with general operations is that the decline in funding has not been accompanied by a decline in spending.

Structure of the Chapter

The following section reviews briefly the nature of 10 deficit reduction strategies we have identified. Each of these strategies represents a category of domestic spending. In each case, we have selected a range of specific program actions to include in our four deficit reduction options. A range of savings for each of these strategies is identified in table 6.2. Detailed selections of illustrative program cuts that underlie these strategies are contained in appendix IV of GAO/OCG-90-5A. As with other parts

of this report, the choice of specific measures is illustrative only. Their inclusion does not imply that we do or do not favor a particular program reduction unless there is a specific statement to the contrary. Nor do we favor any one or set of deficit reduction strategies. These are designed only to provide an organizing principle that avoids the need for the reader to consider the hundreds of possible individual spending reductions. Even when the detailed program cuts are grouped under 10 strategies, there are many possible ways of reaching the four reduction levels.

The last section of this chapter displays various combinations of the 10 reduction strategies to reach four alternative levels of spending cuts, ranging from $45 billion to $170 billion. These combinations are also purely illustrative and not meant to imply a preference for one strategy over another. Appendix IV of GAO/OCG-90-5A includes program lists that provide further background on each of these four choices.

Ten Approaches to Spending Cuts

As we noted earlier, we divided federal domestic spending into 10 categories which form plausible approaches for reducing outlays and allow policymakers to determine how much has been reduced from the major types of nondefense spending. With very few exceptions, each strategy was used to some extent to achieve the four spending reduction levels. Table 6.2 shows the range of usage when each strategy was employed.

Table 6.2: Domestic Deficit Reduction Strategies

Dollars in billions

Strategy	1997 savings From	To
Postpone or reduce nonmeans-tested retirement and disability programs and tax greater portion of Social Security benefits	$5.8	$39.9
Restructure health care	9.6	54.5
Improve efficiency of federal workforce	2.6	9.0
Phase out farm price supports	2.1	8.0
Reduce subsidies to business	2.5	3.9
Reduce subsidies to individuals	0.7	3.1
Increase user charges		
Special benefits	8.5	9.6
Regulatory and inspection costs	3.3	3.3
Market pricing for private use of federal assets	2.2	4.7
Curtail international activities	1.3	1.5
Restrict scientific and medical research	2.3	2.8
Restructure grants to states and localities[a]	•	31.1
Total	**$40.9**	**$171.4**

[a]Another approach would be to reduce grants to states and localities, resulting in savings which range from $1.7 to $14.8 billion.

Nonmeans-Tested Entitlements

The Social Security program dwarfs the programs in this category, sometimes called middle class entitlements. The retirement and disability portions are financed through the Old Age, Survivors, and Disability Insurance trust funds. (The portion that finances medical services for the elderly—Medicare—is discussed separately below.) Although the Social Security system operated primarily on a pay-as-you-go basis in its early years, the Social Security Amendments of 1977 and 1983 have resulted in a partially funded system that has caused the trust fund to begin to run substantial and growing surpluses. As discussed in chapter 2, we believe that these and other trust fund balances should be used to increase the national savings rate.

We favor achieving approximate balance in the general fund portion of the budget. While reductions in Social Security benefits would increase the trust fund surplus (and could thereby increase the national savings rate), they would not reduce the general fund deficit. Nevertheless, there is a way to reduce Social Security benefits and ease the drain on the general fund because much of Social Security is not taxed. Recipients of Social Security benefits continue to be treated much more favorably under the income tax system than recipients of retirement income

from other sources. Correcting this inequity could produce substantial increases in income tax revenues.

The 1983 amendments provided that up to one half of the Social Security benefits received by higher income individuals be included in their taxable income. (The provision phases in when adjusted gross income from other sources exceeds $25,000 for individuals or $32,000 for couples.) At the same time, most new beneficiaries today have paid Social Security contributions during their working years that amount to no more than about 15 percent of the lifetime benefits they can expect to receive. Taxing Social Security in the same way that private pensions are taxed would require beneficiaries to count the other 85 percent (or more) of their benefits as taxable income. Moreover, this approach would be less burdensome than a cost-of-living adjustment (COLA) reduction for lower income beneficiaries because of the progressive nature of the income tax structure.

If this alternative were chosen, we recommend that the amounts collected be deposited in the general fund along with other income tax collections, as is the case for taxes collected on private pension benefits. (Revenues from the limited taxation called for in 1983 have been deposited in the Social Security Trust Fund. In view of the current large and increasing balances, that is no longer necessary.) Strictly speaking, of course, this alternative would reduce the deficit by increasing receipts rather than reducing outlays. However, since it is widely viewed as an alternative to a benefit reduction, we have adopted the convention of displaying it with other benefit cuts.

The full taxation of Social Security benefits in excess of contributions could be coupled with a COLA delay for other middle-income and high-income retirement programs, primarily military and civil service retirement. A 1-year COLA delay, along with the full taxation of Social Security benefits in excess of contributions, would yield about $36 billion in savings by 1997. A more modest alternative would be to (1) impose a 1-year COLA reduction of one half the amount under current law and (2) increase the tax on Social Security benefits to 85 percent but retain the current income thresholds. This approach would yield about $12 billion in 1997.

Restructure the American Health Care System

Substantial cuts in the federal health care budget will be essential if domestic spending restraint is to make a significant contribution to deficit reduction. In view of this, federal health care programs, such as

Medicare and Medicaid, would have to be modified to hold down the short-term growth of costs. These modifications, however, are likely to have only a temporary effect, leaving the growth rate of federal expenditures over the long run unchecked. Controlling the escalation of such expenditures while assuring good quality care to beneficiaries is likely to be very difficult unless the overall rate of expenditure growth in the American health care system is also controlled. Appendix III of GAO/OCG-90-5A discusses the causes of health care expenditure growth and briefly outlines an approach to developing reforms that might bring that growth under control.

To achieve the short-term cost reduction objectives, we have identified in table 6.3 a range of cost-saving reforms in Medicare and Medicaid. At the high end of the range, these changes would significantly reduce general fund and trust fund outlays for these programs. These changes would involve making Part B co-payments substantially higher and increasing Part B premiums above the current rate of 25 percent of the program's actuarial cost. An alternative to raising the Part B copayments would be raising or eliminating the limit on income subject to the Medicare payroll tax and providing the increased revenues for the Medicare Part A trust fund. However, since this taxes future rather than current beneficiaries, it is more appropriately categorized under revenue measures, which are discussed in chapter 7.

Table 6.3: Upper Range of Possible Health Care Reductions

Dollars in billions

Policy change	Savings in 1997
Gradually increase premium to cover 50 percent of costs for physicians' services under Medicare	$32.4
Targeted reduction of disproportionate share and teaching adjustments	4.2
Increase Medicare program safeguard funding (net savings)	1.3
Move immediately to a prospective reimbursement system for capital expenditures under Medicare	1.3
Reduce Medicare's payments to physicians for overvalued services	1.6
Modify way hospitals are paid under federal employees health benefits program	1.3
Reduce VA medical care for nonservice-connected illnesses	5.2
Other	7.2
Total	**$54.5**

At the low end of the range, minimal savings of about $4.1 billion in 1997 could be realized by reforms which would have a less direct impact on Medicare and Medicaid beneficiaries.

At the same time that these short-term budget reductions are being considered, we need to develop a national consensus as to the structural reforms required to bring the health care cost spiral permanently under control. To this end, we believe that the Congress and the executive branch should start now to take the steps necessary to build a consensus among providers, payers, and consumers regarding such reforms.

To provide information which could be used in this process, we are conducting a series of studies of cost containment strategies in the health care systems of other nations. Our preliminary findings suggest that nations which are more successful at controlling health care costs have created institutional mechanisms for setting cost goals; monitoring health care system expenditures; and facilitating resolution of conflicts between the interests of providers, payers, consumers, and governments.

Improve the Efficiency of the Federal Workforce

The federal civilian workforce costs about $120 billion a year, about 45 percent of which is incurred by domestic agencies, excluding the Postal Service. In the past, budget-cutting strategies to limit the growth of personnel costs have focused on limiting the annual adjustments in pay rates for the cost-of-living adjustments. We believe this would be an unwise approach to the issue. There is growing evidence that current federal pay scales (particularly in some high cost localities) are inadequate to attract and retain employees of the caliber needed to carry out government functions with reasonable efficiency. Limiting federal pay COLAs would only worsen the problem.

An alternative strategy would focus on reducing the total cost (relative to the baseline) of the nondefense workforce through aggressive productivity enhancement programs. To implement such a strategy, each agency's total budget for personnel compensation and benefits would be frozen for 1 or more years at the fiscal year 1991 level. Alternatively, the limitation could include some increase, but not the full amount to cover the COLA. Thus, there would be either no new money to fund salaries above those paid in the base year or an insufficient amount. Special accounting measures and controls would be necessary to ensure that the savings are achieved.

General salary increases and some special adjustments could be provided at the discretion of the agency head, but only to the extent that they could be funded from productivity increases that allowed the agency to operate with fewer total staff. If the authorized general salary increase were 4 percent, for example, a 4-percent increase in productivity would need to be achieved before the full amount of the salary increase could be paid.

To be feasible, this workforce improvement program would require new authority for federal managers to remove marginal workers. Such authority would have to recognize the need for due process and protect employees from politically motivated adverse actions. If productivity improvements yielded savings in excess of the amount needed to fund authorized general salary increases and authorized special adjustments (such as locality pay), the agency head would be permitted to distribute a substantial part of the excess to the workforce in special gain-sharing bonuses of up to 25 percent of base salary. The balance of any excess savings would be available for reallocation by the President and Congress to high priority needs elsewhere in the government.

This approach to personnel cost-saving is very flexible. The specific design would depend on the degree to which other domestic budget decisions increased or decreased the need for federal employees.

Phase Out Farm Price Supports

The key to any major reduction in the cost of farm programs is phasing out over 6 years specific crop subsidies, quotas, tariffs, and other similar provisions that impede free and efficient trade. Most U.S. crops do not receive direct, special consideration. The dozen or more crops that receive extensive market protection would have to adjust to operating in open market conditions.

In addition, a similar 6-year phase out of those programs that subsidize specific farmers could be considered. This would include all Farmers Home Administration subsidies and conservation subsidies. Removing specific crop subsidies as well as farm subsidies would improve the opportunity for all U.S. farmers to compete fairly for land and other resources. A change in policy of this magnitude would probably change the U.S. farm structure and cause, at least in the short term, a downturn in the agriculture sector as program funds are withdrawn. In the longer term, however, U.S. agriculture is likely to be stimulated, resulting in new investment, new business interests worldwide, new products, new services, and new customers.

Consumers would benefit from this invigorated agriculture, with more competitive supermarket prices and products. Also, taxpayer savings could range up to $8 billion in 1997. Part of the savings could be invested in new marketing initiatives abroad, a new conservation effort, and improved agriculture research and innovation.

Reduce Subsidies to Business

Several programs that subsidize businesses could be reduced or eliminated because either (1) the conditions originally justifying them have changed, (2) in the context of a comprehensive deficit reduction package (with the prospect of lower capital costs and a stronger economy) they are less essential, or (3) they are ineffective. Table 6.4 lists these subsidies, which go to exporters, some consumers of electric power, coal producers, nonprofit organizations, a small proportion of small businesses, and foreign depositors in U.S. banks.

Table 6.4: Upper Range of Possible Business Subsidy Reductions

Dollars in billions

Policy change	Savings in 1997
End EXIM Bank	$0.3
Reduce REA subsidies	0.8
Reform PMA debt policies	0.3
End clean coal funding	0.5
Discontinue not-for-profit postal subsidies	0.5
Eliminate Stafford loan eligibility for students attending schools with default rates over 40 percent	0.3
End SBA loans and loan guarantees (except minority and disaster programs)	0.4
Other	0.8
Total	**$3.9**

Legend

EXIM = Export-Import Bank

REA = Rural Electrification Administration

PMA = Power Marketing Administrations

SBA = Small Business Administration

Reduce Subsidies to Individuals

Major social arguments can be made for income support programs based on need, service, disability, or some combination of all three. The justification of subsidies to special classes of people who do not qualify for federal assistance on the basis of low incomes is less clear. Table 6.5 lists major programs in this category that could be considered for possible

cuts or elimination. These total an estimated $3.1 billion in outlays for 1997.

Table 6.5: Upper Range of Possible Individual Subsidy Reductions

Dollars in billions

Policy change	Savings in 1997
Eliminate health professions education subsidies	$0.3
End VA home loan program	1.0
Improve correlation between school lunch program subsidies and family income	0.3
Reduce cost and increase borrower payments to 28 percent of income-rural housing program	0.5
Other	1.0
Total	**$3.1**

Legend

VA = Department of Veterans Affairs

Increase User Charges and Fees

User charges and fees can be categorized into three broad areas: payments for special benefits, payments for the costs of regulations legitimately borne by the regulated industry and its consumers, and payment that approximate market pricing, thereby capturing monopoly profits for the taxpayer. Table 6.6 lists options for increasing major user charges and fees. User charges across the full range of these categories could raise up to $17.6 billion.

Table 6.6: Upper Range of Possible User Charge and Fee Increases

Dollars in billions

Policy change	Savings in 1997
Special benefits	
Increase taxes to cover costs imposed by aviation users	$6.7
Extend Bureau of Customs' passenger and merchandise fees	1.0
Other	1.9
Subtotal	**9.6**
Regulatory and inspection costs	3.3
Market pricing for private use of federal assets	
Naval Petroleum Reserve Leasing	0.6
Raise crop insurance premiums	0.6
Impose a royalty payment on communications users of electromagnetic spectrum	2.2
Other	1.3
Subtotal	**4.7**
Total	**$17.6**

Curtail International Activities

Dramatic political, military, and economic changes have swept the world over the past 18 months, providing an opportunity to reshape the budget for international activities in a way that responds to these new realities. Table 6.7 lists activities that could be curtailed to reduce spending in this area. Budgets for the Economic Support Fund and the Foreign Military Financing Program have been linked largely to the U.S. strategy for containing the Soviet Union. Included in these budgets for fiscal year 1991 is over $800 million for three European countries to be used for base access and for strengthening host country forces. With the end of the Cold War, the rationale behind these programs needs to be reviewed. In an additional example, the United States Information Agency has focused its activities on countering Soviet propaganda and promoting the virtues of a free society and a market economy. Detente has led to a much lower level of anti-U.S. propaganda, and developments in Eastern Europe and the Soviet Union have demonstrated the merits of political freedom and market economics. In addition, the Public Law 480 food distribution program could be refocused on genuine humanitarian assistance, with surplus food supplies likely to decline as farm programs become more market oriented. Cuts in these areas could save $1.5 billion by 1997.

Table 6.7: Upper Range of Possible Curtailment of International Activities

Dollars in billions

Policy change	Savings in 1997
Public Law 480 Title 1 Food Aid	$0.9
Economic Support Fund—10-percent cut	0.4
Foreign Military Financing Program—5-percent cut	0.2
Total	**1.5**

Restrict Scientific and Medical Research

While the federal government has a clear role in the support of scientific and medical research, particularly basic research, other research has questionable merit because of its rapid growth or questionable high-cost approaches. Table 6.8 lists research areas that could be cut to facilitate savings. For example, National Institutes of Health research grants have increased 50 percent in real terms between 1983 and 1990. Also, the Superconducting Super Collider and the manned space station (which is largely unfunded in the baseline) are controversial not only in terms of engineering feasibility, but particularly in terms of cost effectiveness. Terminating the Super Collider and manned space station and cutting National Institutes of Health by 10 percent would save $3.3 billion.

Table 6.8: Upper Range of Possible Reductions in Selected Scientific and Medical Research

Dollars in billions

Policy change	Savings in 1997
Cancel the space station	$2.2
Cancel Superconducting Super Collider	0.2
Reduce NIH research funding	0.9
Total	**$3.3**

Reduce Grants to States and Localities

The diversity of problems in U.S. society is matched by the approaches to dealing with them. The federal system permits, within the public sector, responses at the national, state, or local level. Since the 1960s, however, almost no major program designed to assist individuals has been created that is administered primarily at the national level. (An exception is the Supplemental Security Income Program.) On the other hand, some programs may be funded and regulated in such a way as to make them national in everything but name (the Food Stamp Program is a possible example). The appropriate role for each level of government is, of course, a matter of continuing debate as the society as well as the administrative and financial capacities of various levels of government continues to change.

The intergovernmental aid system is based on 492 grant programs that will distribute $133.8 billion to states and localities in fiscal year 1990. In addition, states and localities benefit from $54.1 billion in federal tax expenditures. Federal costs in this area could be reduced through either of two approaches:

- compiling a list of programs that could be cut on the grounds that some regard them as ineffective or
- restructuring the existing federal relationship with states and localities by devolving many domestic responsibilities to the state/local sector.

Under the first approach, which would leave the existing federal system in place, we identified 29 categorical grant programs for termination or restriction. In 1997, this would entail a spending reduction of about $7 billion. By contrast, the second approach could consolidate about 400 grant programs into 6 mega-block grants and reduce them over 6 years to achieve savings of about $20 billion in 1997.

Both approaches can be used to achieve substantial savings. For example, under the restructuring approach, further reductions in the level of the consolidated grants could yield 1997 savings of about $40 billion, which would reduce these funds by about two thirds.

The radical restructuring is based on three premises:

- federal aid to poor people is a higher national priority than other kinds of intergovernmental aid and therefore income security should remain a shared federal/state responsibility;
- states have improved their ability to respond to public service demands and initiate innovation and should be the primary vehicle for policy-making and program administration; and
- federal mandates on state and local governments have increased during a period in which federal aid is declining, and any restructuring should provide maximum flexibility for states to pursue national objectives.

The success of this restructuring would depend heavily on the institutional and fiscal capacities of state and local governments to support and administer the domestic programs involved. Because these capacities vary greatly, the distribution formulas of the federal grants system need to be reviewed to target the remaining federal funds in the light of these capacities.

Illustrative Reduction Packages

The following tables illustrate how these 10 strategies might be combined to produce domestic cuts from $45 billion to $170 billion. The reductions could be arrayed in many different ways. These illustrations suggest the kinds of choices that need to be faced. Of course, any terminations or reductions will be unpopular with beneficiaries of the program. But to achieve deficit reduction, any proposal that is rejected would need to be replaced by another reduction proposal.

In each of the packages, we have shown in the 1992 column the amount that could be saved in that year. Depending on the amount of deficit reduction planned in the defense and revenue components of the budget and the pace at which these amounts are to be achieved, the amount required in the nondefense component in 1992 may be less than is indicated for the packages. This amount can be adjusted as necessary by phasing in the specific reduction items.

Appendix IV of GAO/OCG-90-5A lists the programs from which savings for these four options were selected.

Option 1: $45 Billion Reduction

As we indicated earlier, the smaller reduction packages provide a broader range of choices than larger ones. The particular combination of cuts presented in table 6.9 focuses on new user charges and reduced subsidies to individuals. Cumulatively, these two strategies make up 46 percent of the 1997 overall target.

Table 6.9: Option 1—User Charge and Subsidy Emphasis

Dollars in billions

	Outlay reductions	
Reduction strategy	**1992**	**1997**
Nonmeans-tested retirement and disability	$2.0	$5.8
Health care	6.1	9.6
Federal workforce	2.2	2.6
Farm price supports	2.0	2.1
Reduce subsidies to business	1.6	2.5
Reduce subsidies to individuals	0.5	0.7
User charges		
Special benefits	7.3	9.6
Regulatory and inspection costs	2.7	3.3
Market pricing for private use of federal assets	3.5	4.7
Curtail international activities	0.0	0.0
Slow growth of selected scientific and medical research	1.0	2.3
Reduce grants to states		
Reduction approach	1.5	1.7
Total Reductions	**$30.3**	**$45.0**

As noted earlier, there are many ways to achieve outlay reductions of this magnitude. An alternative would be to selectively eliminate or streamline funding for specific programs. This would entail evaluating factors such as whether (1) existing funding reaches the target population, (2) program objectives are being accomplished, and (3) the stated objective is still a high enough priority to warrant the current level of federal funding or some lower level.

Option 2: $90 Billion Reduction

For this option, presented in table 6.10, the focus shifts to deeper reductions in health care programs with continued emphasis on user charges, subsidies to individuals and businesses, and some reduction in grants to states and localities. A major portion of the savings come from nonmeans-tested retirement and disability programs. While the cuts are large in terms of dollars, they represent only a small percentage of the programs.

Table 6.10: Option 2—Health Care, User Charge, Subsidy, and State Grant Emphasis

Dollars in billions

	Outlay reductions	
Reduction strategy	**1992**	**1997**
Nonmeans-tested retirement and disability	$5.3	$16.9
Health care	14.0	34.9
Federal workforce	2.2	2.6
Farm price supports	1.6	6.2
Reduce subsidies to business	2.1	3.5
Reduce subsidies to individuals	1.7	2.9
User charges		
Special benefits	6.4	8.5
Regulatory and inspection costs	0.0	0.0
Market pricing for private use of federal assets	1.8	2.2
Curtail international activities	1.1	1.3
Slow growth of selected scientific and medical research	1.3	2.8
Reduce grants to states		
Reduction approach	6.8	8.2
Total Reductions	**$44.3**	**$90.0**

Option 3: $120 Billion Reduction

As presented in table 6.11, this more demanding level of reductions shifts dramatically to the nonmeans-tested entitlement programs. As the size of the reduction package increases, it is necessary to look to the programs that compose the bulk of the outlays.

Table 6.11: Option 3—Entitlement, Health Care, User Charge, Subsidy, and State Grant Emphasis

Dollars in billions

	Outlay reductions	
Reduction strategy	**1992**	**1997**
Nonmeans-tested retirement and disability	$18.6	$39.9
Health care	8.5	22.9
Federal workforce	2.5	9.0
Farm price supports	1.6	6.2
Reduce subsidies to business	2.1	3.9
Reduce subsidies to individuals	2.0	3.1
User charges		
Special benefits	7.3	9.6
Regulatory and inspection costs	2.7	3.3
Market pricing for private use of federal assets	3.2	4.4
Curtail international activities	0.0	0.0
Slow growth of selected scientific and medical research	1.3	2.8
Reduce grants to states		
Reduction approach	8.9	14.8
Total Reductions	**$58.6**	**$120.0**

Option 4: $170 Billion Reduction

At this level, presented in table 6.12, we have essentially exhausted the options developed in the 10 strategies. Many will view cuts of this total size as unrealistic. Others might want to consider additional options. This option continues to rely heavily on entitlements, health care, and user charges. Other strategies, such as subsidies to individuals and business, become less significant since they constitute lower and lower portions of the cumulative reductions as the target outlay reductions increase. The remaining factor coming into play as a last resort in this option is the full impact of a reduction in aid to the states. It would result in a major withdrawal of the federal government from existing programs, some of which might be continued with increased state and local support.

Table 6.12: Option 4—Minimal Federal Involvement Except for Self-Financed Programs

Dollars in billions

	Outlay reductions	
Reduction strategy	**1992**	**1997**
Nonmeans-tested retirement and disability	$18.3	$38.7
Health care	16.2	54.5
Federal workforce	2.5	9.0
Farm price supports	1.9	8.0
Reduce subsidies to business	2.1	3.9
Reduce subsidies to individuals	2.4	3.1
User charges		
Special benefits	7.3	9.6
Regulatory and inspection costs	2.7	3.3
Market pricing for private use of federal assets	3.2	4.4
Curtail international activities	1.2	1.5
Slow growth of selected scientific and medical research	1.3	2.8
Reduce grants to states		
Restructuring approach	25.5	31.1
Total Reductions	**$84.7**	**$170.0**

Revenue Alternatives

As the analysis in chapter 3 makes clear, deficits are a burden on the economy and on the taxpayer. Once government has decided to spend a certain amount of money, the real resources represented by that money will be withdrawn from the economy, either through taxes or through borrowing. If the economy is operating fairly close to capacity and the spending is financed by borrowing, the resources will come from reduced domestic spending or increased borrowing from abroad. The taxpayer may not see the direct connection, but will observe the effects in higher interest rates (making it more difficult to buy houses and cars), lower rates of investment by U.S. businesses (meaning fewer jobs are created and real wages are lower), and the increased sale of U.S. assets to foreign citizens and governments.

Taxes extract resources from the economy visibly and directly, but the burden to the nation is no greater. In the long run, the burden would likely be less with taxes, since they will lead to a higher rate of domestically financed investment, producing higher real income for Americans in the future.

This chapter outlines alternative methods of raising revenue at three of the levels of additional revenue needs discussed in chapter 4: $60 billion, $120 billion, and $170 billion annually. There are three broad alternatives for raising these levels of revenues: (1) raising rates within the existing income tax system, (2) broadening the income tax base by including items in the tax base that are currently excluded, and (3) raising existing consumption taxes or introducing new ones. Although any one of these alternatives could potentially be used to raise any of the suggested amounts of revenue, a mixed approach would probably be preferable from an equity and efficiency standpoint, especially for larger amounts.

Mix of Taxes Has Shifted Over Time

Total federal taxes, consisting of both general fund and trust fund revenues, have risen as a percentage of GNP from about 17.5 percent in the 1950s to 19 percent in the 1980s. They are projected to rise to over 19.5 percent in the period from 1990 through 1995. Trust fund revenues have grown in their share of GNP, largely reflecting significant increases in Social Security taxes which are dedicated to financing a particular set of benefits.

However, as noted in chapter 2, the burden of general fund taxes, consisting of individual and corporate income taxes as well as some excise taxes, has fallen from about 15.4 percent to 12.1 percent of GNP during

the same period when the burden of the general fund deficit was growing from 0.9 percent to 5.2 percent of GNP.

The relative contribution of the various federal taxes has changed dramatically over this period. Two components—corporate income and excise taxes—have fallen substantially; one component—employment taxes—has risen substantially; and another component—individual income taxes—has risen slightly. Table 7.1 illustrates this shifting composition of federal taxes.

Table 7.1: Receipts, Outlays, and Deficits

(Percent of GNP)

	1950s	1960s	1970s	1980s
General fund				
Receipts:				
Individual income taxes	7.6	8.0	8.3	8.8
Corporate income taxes	4.9	3.9	2.8	1.8
Excise taxes	2.4	1.5	0.7	0.6
Other	0.6	0.8	1.0	0.9
Subtotal, receipts	15.4	14.2	12.7	12.1
Total outlays	16.3	15.3	15.5	17.3
Deficits	(0.9)	(1.1)	(2.8)	(5.2)
Trust funds				
Receipts:				
Employment taxes and contributions	2.0	3.5	5.1	6.6
Excise taxes	0.1	0.5	0.5	0.4
Subtotal, receipts	2.1	4.0	5.6	6.9
Total outlays	1.6	3.7	5.0	5.8
Surpluses	0.5	0.3	0.6	1.1
Unified budget				
Receipts	17.5	18.2	18.3	19.0
Total outlays	18.0	19.0	20.4	23.1
Deficits	**(0.4)**	**(0.8)**	**(2.1)**	**(4.1)**

Note: Totals may not add due to rounding.

The Aggregate Tax Burden on the U.S. Economy Is Relatively Low by International Standards

The U.S.'s ratio of taxes to gross domestic product is lower than those of almost all of the other members of the Organization for Economic Cooperation and Development. The U.S.'s burden ranks low whether one compares taxes levied by all levels of government in each nation or only those levied by central governments. The exclusion of Social Security taxes from the comparison also has no effect on the U.S.'s relative position. By contrast, the United States has one of the largest deficits as a share of gross domestic product (GDP), ranking fifth out of 22 countries in this dimension.

Table 7.2: Tax Revenues Relative to GDP for 23 OECD Countries, 1988[a]

	Total tax revenue (all levels of government) as a percentage of GDP[b]	Central government tax revenue as a percentage of GDP[b]	Central government tax (excluding Social Security) as a percentage of GDP
Sweden	55.3	40.0	31.3
Denmark	52.1	36.1	35.0
Netherlands	48.2	46.5	26.0
Norway	46.9	37.1	24.6
Belgium	45.1	42.3	27.6
France	44.4	40.1	20.9
Luxembourg	42.8	37.5	26.8
Austria	41.9	33.0	21.5
Ireland	41.5	39.8	34.7
Finland	37.9	28.2	23.4
New Zealand	37.9	35.8	35.8
Germany	37.4	25.6	11.6
United Kingdom	37.3	32.9	26.0
Italy	37.1	36.2	23.9
Greece	35.9	35.2	23.6
Portugal	34.6	32.7	23.4
Canada	34.0	18.8	14.3
Spain	32.8	28.8	17.3
Switzerland	32.5	20.2	9.8
Japan	31.3	23.2	14.1
Australia	30.8	24.6	24.6
United States	**29.8**	**20.6**	**11.7**
Turkey	22.9	20.6	17.1
Unweighted average	38.7	31.9	22.8
U.S. rank out of 23	22	20 (tied)	21

[a]Ranked by total tax revenue as a percentage of GDP.

[b]Includes Social Security taxes.

Each Approach to Raising Revenue Has Limitations

The following revenue discussion is organized around three major approaches to raising revenues. The first would use rate increases under the existing corporate and individual income tax system. The second would broaden the base of the existing corporate and individual income tax. The third would raise existing excise tax rates, introduce new excise taxes, and/or impose a broad-based consumption tax.

Each of these various approaches has advantages and disadvantages. In choosing among revenue options, policymakers should consider not only the revenue raised by a tax but, also, the criteria commonly used in evaluating tax policy decisions. Broadly conceived, these include

Economic efficiency - the extent to which taxes avoid distorting the allocation of resources in the economy and promote economic growth.

Equity - the extent to which taxes distribute the tax burden fairly by (1) providing equal treatment to people in similar circumstances and (2) allocating the tax burden on the basis of ability to pay.

Administrability - the extent to which a tax can be implemented without undue administrative and compliance costs.

Some of these same criteria can also be used to compare any of the approaches and options discussed in the remainder of this chapter with the economic efficiency and income distributional impacts of the nation's current reliance on borrowing and debt to finance the deficit.

Raising Income Tax Rates

The major advantage of using rate increases is that it does not require complicated legislation or additional administrative complexities unless higher tax rates lead to reduced compliance.

Even though the individual income tax has increased compared with GNP, the corporate income tax as a percentage of GNP is less than half of what it was in the 1950s, partly due to such tax changes as lower rates and to higher corporate debt/equity ratios. Moreover, because marginal income tax rates for individuals are very low from a historical perspective, some increase could be justified on the basis of returning rates to levels comparable to those at some point in the past. Since it is a straightforward policy change, estimating the revenue yield is not difficult. Also, identifying who will bear the tax burden would be simple, with the notable exception of increases in the corporate income tax rate

since the ultimate incidence of this tax is a subject of much disagreement among tax analysts.

The primary disadvantages of higher tax rates are the effects on incentives and changes in behavior resulting from those incentives. For example, higher income tax rates in general reduce the incentive to work and to save, but there is little evidence that the effects are very large. Of more concern is that higher taxes on certain forms of income make other untaxed forms of income more attractive. This effect makes the cash and barter economy more important. It also makes purchasing a home and taking compensation in the form of untaxed fringe benefits rather than as regular wages more attractive. The effect of higher tax rates on all of these types of decisions reduces the overall efficiency of the economy, though the effect can be mitigated by a broad tax base.

Broadening the Income Tax Base

Broadening the current income tax base by including some items currently excluded or eliminating certain deductions would have a number of equity and efficiency advantages. The equity advantages are twofold. First, people with the same income do not currently pay the same tax when some of them receive their income in tax-preferred or tax-exempt form while others do not. Second, the items that are excluded or deducted from the income tax base, such as income on pension funds or state and local income taxes, are much more concentrated among upper income groups. Broadening the tax base would therefore enhance equity between those with similar incomes, since type of income would be less relevant, and it would increase the effective progressivity of the tax system.

The efficiency effects result from reducing the difference in the effective tax rate on alternative forms of income. Under the current system, people have an incentive to "consume too much" health insurance, retirement benefits, and housing, because the tax system subsidizes them. Reducing or eliminating tax preferences would treat all forms of income in a more balanced way, leveling the playing field even more than the Tax Reform Act of 1986 did.

The staff of the Joint Committee on Taxation (JCT) has estimated that the revenue yield of the income tax in 1995 would be $406.7 billion larger with the use of a broad based definition of income in comparison

with the current definition.[1] A list of the larger tax expenditures is included in table 7.3. A more comprehensive list, containing over 120 separate tax expenditures that each amount to more than $10 million per year, was prepared by JCT staff and published as Estimates of Federal Tax Expenditures For Fiscal Years 1991-1995.

Table 7.3: Estimates of Largest Tax Expenditures—1995

Dollars in billions	
Net exclusion of pension contributions and earnings	$61
Exclusion of employer contributions for health insurance	50
Deductibility of mortgage interest on owner-occupied housing	40
Deductibility of nonbusiness state and local income and personal property taxes	27
Exclusion of untaxed social security benefits	26
Excess depreciation	25
Deferral of capital gains on sales of principal residences	14
Exclusion of interest earned on public purpose state and local government debt	14
Exclusion of investment income on life insurance and annuity contracts	10
Total	**$267**

Note: Dollar figures would be realized only if the elimination of the various exclusions and deductions applied to existing beneficiaries as well as future beneficiaries. The total amount in the table does not recognize interaction effects.

There are two disadvantages to broadening the income tax base. First, many of the items excluded from the tax base are excluded for a particular social purpose. Mortgage interest is excluded because, at least in part, owning one's own home is thought to be socially beneficial. Retirement security and protection against large health-related outlays lay at the base of the special treatment given pensions and employer-provided health benefits. The second disadvantage is that each of these tax expenditures has a powerful political constituency behind it. Most of the base broadening alternatives discussed here were suggested by the Treasury Department in early tax reform proposals in 1985. However, the alternatives met with such opposition that they were discarded, under the then-existing ground rules of a revenue-neutral package. Similar focused opposition is likely to arise again, unless the affected groups are made aware of the burdens they currently bear in financing the government through borrowing. Strategies for overcoming opposition could include adopting across-the-board cuts in tax expenditures to spread the sacrifice over a larger number of taxpayers.

[1]This figure was derived by adding the revenue loss for each tax expenditure and does not account for the interaction effects among the various tax expenditures.

One additional point needs to be made about base broadeners. There are a set of provisions in the tax code that are set to expire in 1990 unless Congress acts to extend them. These provisions are not counted in the baseline for calculating tax expenditures. If they are extended, there will be additional revenue losses that must be made up, either through expenditure reductions or tax increases. However, if they are allowed to expire, there will be no need to alter our calculations. The staff of the JCT has estimated that these expiring provisions would lose over $6 billion in 1995 if they were extended. Included among these provisions are the research and experimentation tax credit and the low-income housing credit.

Consumption and Excise Taxes

There are two primary types of consumption taxes, those levied on a narrow base of goods or services—excise taxes—and those levied on a broad tax base such as value-added and retail sales taxes. The arguments for excise taxes are somewhat different than the arguments for broad-based consumption taxes. Excise taxes were once a very important source of revenue and were often raised to finance wars and national emergencies. However, these taxes have declined as a share of total revenues since most are imposed on a dollar-per-unit basis and ad hoc adjustments to their rates have not kept up with inflation.

In recent years, they have often been proposed as revenue raisers that also discourage particular types of activity. For example, excise taxes on tobacco and alcohol can be viewed as attempts to discourage smoking and drinking. A related perspective is that these taxes should compensate society for the costs the particular activities impose.

In contrast, one of the major advantages of a "pure" consumption tax covering all goods and services is that it is neutral with respect to the choice of which goods and services are consumed as well as the choice between consumption and savings.[2] If rebates are paid on exports and taxes are imposed on imports, there is also no advantage or disadvantage for domestic as compared with foreign goods. Even though the income tax is biased against saving and the consumption tax has no such bias as long as current saving is for future spending, there is little evidence that a consumption tax would raise the national savings rate to any significant extent if substituted for an income tax.

[2]If a consumption tax were to follow the experience in other countries of exempting a number of goods and services to reduce regressivity, it would introduce some distortions into consumption choices.

The primary argument against raising existing excise taxes—an argument that also applies to broad-based consumption taxes—is that these taxes are regressive or have a disproportionate impact on lower income groups. Very low income groups tend to consume larger portions of their annual income than do higher income groups. However, differences in consumption relative to income are not that substantial if we look at these patterns over more than 1 year. In fact, only at the very highest income levels does the proportion of income consumed fall off very much.[3] Consumption patterns for particular items such as tobacco products, alcoholic beverages, and motor fuels are generally similar to those for overall consumption. As a result, the regressivity of consumption and excise taxes is often overstated.[4]

Regressivity, at the low income end, can be offset through some combination of indexed income support programs or refundable tax credits. However, because there is little that can be done to offset the regressivity of a flat rate consumption tax for very high income levels, the tax package would be mildly progressive at low incomes and regressive at very high income levels unless a compensating change were made to increase effective tax rates at the high income level.

A second argument against introducing a broad-based consumption tax is that it would take substantial up-front resources and lead time—something like 18 months has been suggested—to get the system up and running. The additional tax would probably be administered by the Internal Revenue Service (IRS), increasing the urgency of already needed managerial improvements. In addition, the Customs Service would probably be responsible for dealing with exports and imports. Therefore, Customs responsibilities would be greatly extended and coordination between the IRS and Customs would have to be substantially strengthened.

Finally, a broad-based consumption tax would also generate opposition from state governments, since many consider the retail sales tax as their tax. The majority of state tax policymakers responding to a 1989 GAO

[3]The appendix volume (GAO/OCG-90-5A) provides further discussion of the distributional effects of the various revenue proposals discussed in this chapter.

[4]A recent CBO study showed that the impact of gasoline, alcohol, and tobacco taxes on the lowest income quintile may be overstated by a factor of two, if annual rather than long-run income is used.

survey opposed a broad-based federal consumption tax, viewing it as an intrusion on state tax systems.[5]

Options for Raising Revenue

To illustrate the full implications of each approach to raising revenue, we initially show how each alternative amount could be raised using a single approach. We illustrate and discuss the implications of raising three levels of annual revenue by 1997: $60 billion, $120 billion, and $170 billion. As the amount of revenue to be raised increases, reliance on a single approach becomes less and less reasonable. Therefore, since it is likely that a mixture of approaches would be more acceptable, we have also developed illustrations combining approaches.

It is important to keep in mind that the revenue targets could be reached through any number of combinations. To illustrate this point, we selected a variety of options through which to achieve the revenue objectives. Thus, our use of a given option should be viewed as illustrative and not construed as implying our endorsement of that particular approach.

We drew most of our specific options from CBO's February 1990 report on deficit reduction because it addressed an extensive array of options and provided corresponding 5-year revenue estimates prepared by the staff of the Joint Committee on Taxation.[6] The revenue estimates are based on the economic assumptions prevailing at that time. The estimates for all the options discussed in this chapter as well as some others presented by CBO are included in a separate volume to this report; information describing the distributional effects of the various options discussed in this chapter is also presented in that volume. In each of the options we present, we vary the base broadeners to demonstrate that there are a variety of ways base broadeners could be combined to reach revenue totals, and we do not intend to suggest that any given package of base broadeners necessarily corresponds with a particular level of revenues.

[5]Tax Policy: State Tax Officials Have Concerns About a Federal Consumption Tax (GAO/GGD-90-50, March 1990). It should be also noted that, from the perspective of the federal government, the growth in states' reliance on the income tax could be viewed as an intrusion on the federal income tax base.

[6]Congressional Budget Office, Reducing the Deficit: Spending and Revenue Options, February 1990. Additional sources are listed in appendix V of GAO/OCG-90-5A. We projected revenue figures beyond fiscal year 1995 through fiscal year 1997, generally by extending the growth trends in the relevant source.

Options for Raising $60 Billion

Although a single approach is not necessarily preferable at any revenue level, using only one approach to raise $60 billion is more reasonable than using a single approach to raise larger amounts. To raise $60 billion, the requisite rate increases would be more modest than at higher amounts and fewer loopholes would have to be eliminated. It also becomes more reasonable to simply limit certain tax expenditures without eliminating any. While it would require large excise tax rate increases and new excise taxes, it would be feasible to raise $60 billion with excise taxes alone. However, introducing a new broad-based consumption tax such as a value-added tax (VAT) does not appear warranted for this lower revenue level, given the substantial startup and lead time involved. The following discussion summarizes an array of options for raising $60 billion in new tax revenues.

Summary of Selected Options for Raising $60 Billion

Income tax rate increases

Raise individual rates to 16 percent, 30 percent, and 33 percent.
Raise corporate rate to 35 percent.

Income tax base broadeners

Eliminate one or two of the largest tax expenditures or cap a whole range of tax expenditures (see table 7.4 for an example).

Consumption-excise taxes

Increase excise taxes on alcohol to restore their 1970 value, and equalize based on the rate for distilled spirits.
Double the tax on cigarettes.
Raise motor fuels tax by 20 cents a gallon.
Impose tax on transfer of securities.

Mixed income tax rate-excise taxes

Add a 33 percent individual tax bracket.
Increase excise taxes on alcohol and tobacco as above.
Raise motor fuels tax by 20 cents a gallon.

Mixed base broadeners-excise taxes

Subtract itemized deductions only on the basis of 15 percent marginal rate.
Raise motor fuels tax by 20 cents a gallon.

Using a Single Approach Could Raise $60 Billion

If marginal individual income tax rates were increased to 16 percent, 30 percent, and 33 percent, and the highest corporate income tax rate were increased to 35 percent, CBO has estimated that about $60 billion in additional revenue would be raised.[7] Other combinations of rate increases also could be considered to raise $60 billion. The lowest bracket rate generates the most tax revenue per percentage point tax increase, because it applies to the most taxable income. Therefore, if increased progressivity is desired, it would require much larger rate increases in high income brackets to generate sufficient revenue. For example, if the lowest bracket is to remain at 15 percent, the top bracket would have to increase to about 40 percent to raise the required revenue.

On the other hand, eliminating a small set of the larger tax expenditures could also generate $60 billion. In fact, taxing pension income and contributions fully would raise about $60 billion. Alternatively, including employer-provided health insurance premiums in income along with closing a few small loopholes could also raise the required amount. However, $60 billion could also be generated by capping or limiting a number of tax expenditures. The advantage of this last approach is that the social goals that are the basis for these tax benefits can still be achieved, at least in part, but the forgone revenues, especially those accruing to higher income groups, can be limited. The disadvantage would be a slight increase in complexity, especially if certain fringe benefits are to be included in income. Some tax expenditures that could be capped or eliminated are shown in table 7.4.

[7]The CBO estimates include a rate increase for the so called "phase out" range of taxable income. In this range, the benefit of personal exemptions and taxation at the lowest marginal rate is removed through a 5 percent surcharge. Thus, the effective rate structure would be 16 percent, 30 percent, 35 percent, and 33 percent.

Table 7.4: Revenue Effects of Capping or Eliminating Certain Tax Expenditure

Dollars in billions

Change in taxation	Revenue raised
Tax at a 5-percent rate investment income on life insurance, annuities, pensions and IRAs	$12
Tax 50 percent of Social Security benefits	10
Tax 30 percent of capital gains from home sales	10
Cap employer-paid health insurance benefits at $3,000 per year	10
Cap deductibility of state and local taxes at 9 percent of adjusted gross income	7
Disallow deductions for 50 percent of meals and entertainment expense	5
Tax employer-paid life insurance benefits	3
Limit mortgage interest deduction to $12,000 for individual and $20,000 for joint return	3
Eliminate all private purpose tax-exempt bonds	3
Tax capital gains held until death on a carryover basis	2
Total	**$65**

Using excise taxes to raise $60 billion would probably require either a large increase in taxes on motor fuels or some new energy or environmental taxes.[8] Increasing excise taxes on alcohol and tobacco could raise over $30 billion, if the alcohol taxes were based on alcohol content and if the rates were raised to levels equivalent to their 1970 values, and if cigarette taxes were doubled. A motor fuels tax increase of 20 cents a gallon would raise almost $20 billion more. To reduce the regressivity of this option, a tax on the transfer of securities could be included.

There does not appear to be sufficient reason to introduce a VAT if only $60 billion in new revenue is required. Since a 5-percent comprehensive VAT with no exceptions raises $180 billion, a 2-percent VAT would raise over $70 billion. However, given the set-up costs and additional administrative and compliance costs, as well as the amount of lead time required for implementation, it does not appear worth it for so little in new revenues. An alternative would be a VAT with exemptions for basic goods to reduce the regressivity of the tax. A problem with this option is that the exemptions make the tax harder to administer and give benefits to people who consume exempt goods whether they are rich or poor. A more savings or investment-oriented approach might use the extra consumption tax revenue raised by a higher-rate VAT to either cut taxes on

[8]Increases in the motor fuel tax raise an additional concern. Currently, these taxes are devoted to trust funds. Using any additional revenues from this tax to offset the general fund deficit would require changes in the underlying legislation. The same is true for revenues generated by higher taxes on Social Security benefits.

corporate investment by reinstating the investment tax credit or liberalize the constraints on using individual retirement accounts (IRAs) or other tax-preferred savings instruments. The evidence on the effectiveness of these devices is very mixed, so it is not clear that national savings would go up or that efficient investment spending would be increased on a long-term basis.

Combination Approaches to Raising $60 Billion

Revenues of $60 billion could also be raised by some combination of two or three of the approaches, such as a mix of excise tax increases and income tax base broadeners. For example, to offset the concern that excise tax increases might fall most heavily on the poor, base broadeners could be selected that would affect other income groups more heavily. To mitigate the political controversy associated with limiting selected base broadeners, taxpayers could be allowed to subtract itemized deductions only on the basis of the lowest marginal tax rate (currently 15 percent). Alternatively, the same goal could be accomplished by combining a 33-percent individual income tax rate with increased excise taxes.

Options for Raising $120 Billion

If some intermediate amount of revenue, such as $120 billion needs to be raised, then either a single approach or some mixture of approaches could be employed. The following section illustrates some possible options for raising $120 billion using three pure approaches and two mixed approaches.

Summary of Selected Options for Raising $120 Billion

Income tax rate increases

Increase individual rates to 17 percent, 32 percent, and 36 percent. Increase corporate tax rate to 36 percent.

Income tax base broadeners

Eliminate or cap a range of base broadeners.

Consumption tax

Impose a 5-percent value-added tax with one-third of revenue set aside to offset regressivity through tax rebates or low-income entitlements.

Mixed income tax rate-base broadener approach

Raise individual income tax rates to 16 percent, 30 percent, and 33 percent.
Raise corporate rate to 35 percent.
Cap or eliminate an assortment of deductions or exclusions from income tax base for remainder.

Mixed consumption-income tax base broadener approach

Raise cigarette tax to 32 cents per pack.
Increase taxes on distilled spirits, beer, and wine to 25 cents per ounce of alcohol.
Impose a $5 per barrel tax on domestic and imported oil.
Impose tax on mobile and stationary sources of air pollution.
Impose tax on water pollutants.
Cap or eliminate an assortment of deductions or exclusions from income tax base for remainder.

Using income tax rates alone is certainly feasible. However, as the amount of revenue needed rises, the rate increases necessary will also rise. Because higher rates are likely to decrease the overall efficiency of the economy, there may be some limit on how high the rates should rise. Increasing individual tax rates to 17 percent, 32 percent, and 36 percent, along with increasing the corporate rate to about 36 percent would generate about $120 billion.[9]

Base broadeners could raise this amount as well. Again, this approach runs counter to the social purpose of these tax expenditures, and the cost/benefit trade-off needs to be taken into account. Many combinations of a few large or several smaller tax expenditures could be eliminated to raise $120 billion. It would be hard to generate all of the revenue by simply using caps on existing tax expenditures unless the caps were very low.

A pure consumption tax approach to anything above about $80 billion would probably have to be broad based since excises are very unlikely to provide sufficient revenue. Such a broad-based consumption tax, even one with a generous tax rebate and income support program to reduce regressivity, could readily raise $120 billion.

[9]Because the CBO estimates include a 5 percent surcharge for the "phase-out" range, the effective rates are 17 percent, 32 percent, 37 percent, and 36 percent.

If the consumption tax approach is used, the basic trade-off would be between the overall efficiency of a broad-based consumption tax versus the setup and ongoing administrative costs of moving to a new tax regime. The trade-off between consumption and income taxes is generally one between efficiency and equity. A VAT or a national retail sales tax has certain efficiency benefits because it is neutral between consumption and savings. The income tax, on the other hand, has greater flexibility to deal with equity issues more effectively.

A mixed approach could have either an income tax or a consumption tax orientation. If the income tax approach is used, then it could combine base broadeners with rate increases. If the allowed group of base broadeners is very limited, then more revenue must be generated through higher rates.

A consumption-oriented approach could use a combination of increased excise taxes and base broadeners to reach the $120 billion target. When considered as a package, this approach could realize some of the advantages of excise taxes while offsetting the regressivity of these taxes with progressive base broadeners.

Options for Raising $170 Billion

In this section we discuss a set of options that might be used to raise the maximum amount of additional revenue postulated in chapter 4. First, we looked at what sort of income tax rate increases, base broadeners, or consumption/excise tax package would be necessary to achieve $170 billion in additional revenue by 1997. Since the results are quite extreme, we then turn to a few mixed approach packages that could achieve the same goal. A summary of these packages is presented in the following section.

Summary of Selected Options for Raising $170 Billion

Income tax rates only

Raise individual rates to 18 percent, 34 percent, and 37 percent.
Raise corporate rate to 36 percent.

Base broadeners only

Eliminate the top four tax expenditures listed in table 7.3.

Consumption tax only

Impose a 5-percent value-added tax.

Mixed income tax rate-base broadener approach

Raise individual rates to 16 percent, 30 percent, and 33 percent and raise corporate rate to 35 percent.
Cap or eliminate an assortment of deductions or exclusions from income tax base for remainder. (See table 7.5 for an example.)

Mixed consumption-income tax rate approach

Impose a 5-percent value-added tax with adjustment to offset regressivity
Add a 33 percent bracket.
Raise top corporate rate to 36 percent.

Using Only One Approach to Raise Revenue Appears Extreme

There are a number of ways that income tax rates could be used to raise $170 billion. In our analysis, we will attempt to keep the proportional differences in rates reasonably consistent with those that currently exist. Extrapolating from data published by CBO, we calculate that an individual rate schedule of 18 percent, 34 percent, and 37 percent, along with a corporate rate of 36 percent, would generate the $170 billion.

There are certain trade-offs within this approach. Each percentage point increase in the lowest tax rate generates about $21 billion, whereas each percentage point increase in the middle bracket generates over $15 billion. At the upper end, a percentage point only produces $3 billion. Our extrapolations of CBO's estimates for the corporate income tax imply about $3 billion for each percentage point increase in the rates.[10] Most combinations of rate increases sufficient to raise $170 billion would raise average marginal tax rates back to levels that existed in the 1970s, when they were higher than any period since World War II, and apply them to a broader income tax base. However, the highest marginal rate would still be well below the 70 percent rate that was in effect as late as 1980.

[10]It should be noted that the higher rates become, the less revenue each additional percentage point increase will bring in because of base erosion. For this reason, extrapolation of revenue generated by the larger rate increases may be overstated.

Using base broadeners to raise $170 billion means ending preferred tax treatment for some long-standing forms of untaxed or undertaxed income. The staff of the Joint Committee on Taxation estimates that the total value of tax expenditures will be about $400 billion in 1995. Of this, almost 90 percent relates to the individual income tax. As is shown in table 7.3, the top five tax expenditures add up to $200 billion of the $350 billion in tax expenditures attributable to the individual income tax. What this means is that $170 billion cannot be raised under this approach without touching some of the largest tax expenditures. It also means that all of the required amount could be raised if these five were eliminated, assuming that the tax changes were applied to all existing pensions, mortgages, or other long-term arrangements as well as to new ones.

If any one or any set of the tax expenditures is considered off limits, some other set of base broadeners must be substituted. For example, if the deductibility of state and local taxes is continued, $27 billion in revenue needs to be made up by including items further down on the list. Some candidates might be the deferral of capital gains tax on the sale of a principal residence and the exclusion of interest on state and local bonds. If both were included in income, they would add up to about the same as eliminating the deductibility of state and local taxes.

It is not realistic to expect to raise $170 billion from excise taxes alone. In order to construct a meaningful consumption tax package that will raise that much money, we need to include some broad-based consumption tax, like a value-added or national retail sales tax. According to our extrapolation of CBO estimates, a 5-percent value-added or retail sales tax on a very comprehensive base would raise over $180 billion in 1997. This would allow about $10 billion to be used to offset regressivity.

Any chipping away at the VAT base would require higher taxes on particular goods if the entire amount is to be raised from consumption taxes. For example, if food, housing, and medical care were eliminated from the VAT base, the net revenue raised by a 5-percent VAT would be close to $116 billion annually. This means that the VAT rate would have to be raised, or that some set of excise taxes would have to be raised substantially, if the entire $170 billion is to be generated by taxes on consumption.

All of these pure approaches present some important difficulties. Significantly higher tax rates could reduce the overall efficiency of the

economy by, for example, reducing work and savings incentives. However, if the revenues generated permit significant deficit reduction, the net effect on the economy could be positive.

Closing remaining loopholes in the income tax system to raise $170 billion would raise substantial opposition. It is also true that many of these tax expenditures do serve a social purpose, at least to some extent. Eliminating the tax expenditure completely may not make sense from a social cost benefit perspective. For example, eliminating the tax expenditure for health insurance could substantially reduce the private provision of health insurance and, as a result, increase financial demands on the health delivery system.

The consumption/excise tax approach does reasonably well on efficiency grounds; however, it may fall short on equity grounds. Whether or not the federal tax system has become less progressive over the last decade, this kind of tax increase would reduce the progressivity of the system substantially unless other compensating tax or expenditure changes were made.

A Mixed Approach Is Called For

While a number of mixed approaches are possible, we will focus on two alternative ways to raise $170 billion. One of these is an income tax approach that combines rate increases and base broadeners. The second is primarily a consumption tax approach, but it includes certain income tax features to offset some of the regressivity inherent in the consumption tax.

Increasing the first bracket from 15 to 16 percent, the second bracket from 28 to 30 percent, extending the 33 percent rate to all taxable income above $70,000 for a married couple, and raising the corporate rate to 35 percent would raise about $65 billion. To generate the additional $115 billion necessary under the income tax approach would require a set of base broadeners or further rate increases. Raising this much revenue using base broadeners probably means eliminating one or two of the larger tax expenditures. The illustration in table 7.5 places limits on certain tax expenditures, including a large proportion of Social Security benefits and eliminates the deductibility of state and local taxes.[11]

[11] In chapter 6 on nondefense spending, one of the options included taxation of Social Security benefits in lieu of restricting the COLA for that program. However, since the $170 billion revenue option would involve no nondefense reductions, including taxation of Social Security benefits in this revenue option does not constitute double counting.

The revenue estimates in table 7.5 are based on the existing rate structure. If the level of rates is raised, the amount of revenue generated by closing loopholes will go up. If taxing 50 percent of Social Security benefits or including all of state and local taxes in taxable income is considered too extreme, less extreme restrictions could be substituted. However, these weaker restrictions would not generate as much revenue. As a result, either the restrictions would have to be tightened, some other tax expenditure would have to be included in the list, or some rates would have to be further increased.

Table 7.5: Illustration of Raising $115 Billion From Selected Base Broadeners

Dollars in billions

Restriction on tax expenditure	Revenue raised
Eliminate deductibility of state and local taxes	$41
Tax 50 percent of Social Security benefits	10
Impose a 10-percent tax on investment income of life insurance, annuities, pensions, and IRAs	25
Limit deduction for mortgage interest to 15 percent rate	19
Cap deductible health insurance premiums at $3,000 per family per year	10
Disallow 50 percent of deduction for meals and entertainment expenses	5
Tax capital gains held until death on a carryover basis	2
Tax employer-paid life insurance premiums	3
Total	**$115**

The second approach would begin with a broad-based consumption tax that would raise about $180 billion with a 5-percent rate. However, some of this revenue would be set aside to deal with regressivity at the lower end of the income scale. To be conservative, we would devote 20 percent of tax revenue to tax rebates and low income entitlement programs in an attempt to offset the impact of the tax on low income households. This would leave net revenue of about $140 billion. The consumption tax has a much smaller proportional impact on very high incomes, so to raise the additional revenue and to add some progressivity at the upper end, an increase to 33 percent in the tax rate applying to high incomes might be suggested. This would generate about $14 billion in additional revenue. If the top corporate rate were also raised to 36 percent, another $7 billion could be raised.

Transition Issues Should Be Considered in Phasing in Changes

There are two general concerns about the transition to new tax rules. The first involves changing the ground rules under which taxpayers have organized their economic affairs. Employees have entered into fringe benefit agreements with their employers and individuals have made important decisions concerning housing choices and retirement savings all under the expectation that various tax preferences would remain in existence. Thus, there may be good reason to ease the shock of changing these ground rules. For example, if the mortgage interest deduction is terminated, one approach would be to disallow some increasing proportion of the mortgage interest deduction over a phase-in period of several years. Similarly, dramatic increases in the gasoline excise tax or the imposition of a new, broad-based energy tax could be phased in over a period of years. This approach would allow taxpayers to adjust to the changed environment more gradually and is consistent with how the Tax Reform Act dealt with eliminating the consumer interest paid deduction.

The second concern centers around the macroeconomic effects of any substantial shift in fiscal policy. As discussed in chapter 3, the shift will be beneficial to the economy in the long run, but could cause a substantial reduction in aggregate demand in the short run. Thus, the combination of tax increases and spending cuts (including debt service savings) each year should total about $50 billion. Both spending cuts and tax increases should be phased in to conform to that pace if the fiscal policy target is to be reached without undue risk to the economy. However, if income tax rates are to be raised, this should be done in the earlier years, to avoid creating an incentive to shift the reporting of income between years. Thus, the timing as well as the magnitude of spending and tax changes are interrelated.

There is an additional specific reason for a transition period in the case of the value-added tax. This is the only new tax that involves a large administrative structure and an extensive taxpayer education effort. As a result, it will probably take about 1 to 2 years after passage of a VAT for the tax to actually be put into effect. If the VAT is an important part of an agreed-upon package, this means either taking into account the phasing in of revenue or imposing some transition tax to fill in the gap.

Enforcement of a Multiyear Budget Agreement

New procedures to enforce a budget agreement may be part of, but are separable from, the broader topic of budget reform, which is discussed in chapter 9. For example, a constitutional requirement for a balanced budget is often mentioned as a possible budget reform issue, but it has little to do with enforcing the provisions of a budget agreement. In this chapter, we discuss procedures for enforcement without making a recommendation. In chapter 9, we outline our position on budget reform.

In the U.S. political system there is no certain way of ensuring that future action will be consistent with a budget agreement. Indeed, any completely effective enforcement mechanism would be inconsistent with the democratic process. That is why we continue to emphasize the need for a clear multiyear agreement supported by the congressional leadership and the President. We do not believe that enforcement procedures are an effective substitute for that bipartisan support. Nonetheless, we have been asked for our analysis of enforcement alternatives, and we are aware that there is considerable support for the view that better enforcement should be an integral part of any new budget agreement.

In this chapter we consider four approaches to enforcement which are not mutually exclusive.

- The first is improving the structure, clarity, and implementation of an agreement. This does not involve any new procedures, but makes any other procedures, including the ones now in place, more effective.
- The second enhances the executive branch's ability to reverse legislative actions that are inconsistent with an agreement.
- The third creates or improves congressional procedures to make it difficult for the Congress itself to violate an agreement.
- The fourth provides specific remedies such as those provided in the GRH sequester process. In cases where violations take place, these remedies are designed to offset the effect of the violation, provide an incentive to avoid a future violation, or both.

The second, third, and fourth approaches all involve substantial procedural changes and have their drawbacks. Procedures enhancing executive authority will concern those who oppose a shift of power between the branches. Changes in legislative procedures will face skeptics who point out that even if codified in law, such procedures can be waived or changed by simple majority votes in the Congress. The fourth approach has the disadvantage of automatic formula budgeting that has plagued the GRH sequester process.

Increasing the Effectiveness of All Approaches

The 1987 agreement provided ample evidence of the importance of clear and explicit terms. Much of the agreement was adhered to; however, difficulties arose when there was disagreement or ambiguity as to its meaning. In this regard an agreement would be easier to enforce if it used caps on specific expenditure categories and floors on revenues rather than deficit targets, as GRH does.[1]

Another general feature to improve enforcement would be the creation of an independent review board to monitor the implementation of the agreement. This board would have quite different responsibilities from the budget concepts commission recommended in chapter 9. It would rule on whether targets were being met, the legitimacy of questionable budgeting or financing practices, and the reasonableness of economic assumptions. The rulings of such a board could be either advisory or mandatory, although if they were mandatory it would probably have to be an executive branch agency to avoid arguments about the separation of powers.

It may also be desirable to enact as many of the provisions of an agreement as possible the first year on a multiyear basis. By locking in the bulk of the savings, even those that are not effective until later years, it would be harder for future presidents and Congresses to undo the intent of an agreement. All changes in the tax code, entitlements, and other mandatory programs, user fees, and asset sales could be included in a reconciliation bill. Such a bill could also include any legislation needed to improve enforcement. Multiyear appropriations could also be enacted incorporating agreed-to levels for discretionary programs minus a reserve for future contingencies.

Enhanced Executive Authority

Additional enforcement powers that could be given to the President include item veto, enhanced rescission authority, some form of entitlement authority, and a second sequester process.

Item veto authority would give the President the ability to pick and choose among items of appropriation as to where he would propose to offset what he determined to be an overage in an appropriation. Enhanced rescission would permit the executive to make that determination at any level of detail because rescissions may be proposed for

[1]Spending caps should be separate for defense, Social Security (or all trust funds), other mandatory entitlement programs, nondefense discretionary programs, interest on the debt, and the Resolution Trust Corporation's savings and loan bailout payments. Receipt floors should be divided into Social Security (or all trust funds) and other receipts.

part of an appropriation account. It is not clear why these powers are explicitly related to enforcement of a budget agreement except to the extent that they enhance presidential power in general and could be used to help enforce an agreement, as well as for other unrelated purposes. If an appropriation is in excess of an agreement allocation (assuming this can be determined given that normally the 13 appropriations bills are acted upon at different times), it appears that the appropriate remedy would be a normal veto, which would force the Congress either to override or meet the target within its own set of priorities. The item veto (or the enhanced rescission option) raises the related question as to its use in instances where the Congress met the agreement target but included items to which the President objected. If these powers are related strictly to enforcement of an agreement, then presumably their use would be restricted solely to instances where the agreement levels had been exceeded.

The authority to adjust administratively entitlement benefits if an agreement goal is not reached now exists only under carefully specified circumstances in connection with the GRH sequester. It might be provided in the future, possibly with the restriction that it is to be used only when the Congress has agreed to, but has not enacted, reconciliation legislation designed to achieve savings contained in a budget agreement. This remedy could be justified on the grounds that in the absence of legislation the President's veto power does not apply. It would also provide the Congress a strong incentive to comply with the terms of a budget agreement. In view of these factors, it is curious that it has not been more widely discussed in the context of the current budget negotiations.

A "second sequester" process, which has been suggested as a possibility by the administration, raises at least as many problems as it solves. One reason it is advocated is to correct any unduly optimistic economic or technical estimates that were made with the first sequester. Yet it also would be entirely based on estimates, albeit with 2 months of actual outlay data and some additional economic data available. Furthermore, the estimates would be entirely under the control of the executive branch. The second sequester, if it took place, would be even more disruptive to agency operations than the first one, since the fiscal year would be well underway. Those activities that would be less likely to be disrupted, such as long-term procurement, would also be those that produced relatively low short-term outlay savings.

Improved Congressional Processes

The Congressional Budget Act established procedures by which the two Houses of Congress would make the individual legislative actions fit into the overall targets contained in the budget resolution. Those procedures have changed, most notably with the enactment of GRH. A number of further changes are under consideration. For the House one option would make it more difficult to waive points-of-order on exceptions to the budget resolution by requiring super majorities and limiting the authority of the Committee on Rules. A more major change would be to capture multiyear implications of current decisions in the enforcement process. This could be done by subjecting future fiscal years to the same legislative process that now applies only to the next fiscal year. Another alternative would restructure the budget resolution, which is now based on nonbinding allocations by budget functional categories, in terms of binding allocations that coincide with jurisdictional boundaries of the Congress. Allocations to appropriations committees could be specified along the lines of the 1987 budget agreement, so as to establish clear guidelines on the suballocations to defense, international, and domestic programs. These suballocations could be divided into mandatory programs under the jurisdiction of authorizing committees, and discretionary programs that are the responsibility of the appropriations committees. Further allocations of discretionary appropriations could be made by subcommittee (the so-called Section 302-b allocations).

These and other procedural reforms essentially deal with the degree to which the Congress wants to focus more authority on the centralized budget process, which is under the direction of the budget committees and the leadership, at the expense of the authorizing and appropriations committees.

These are only some of the important ideas on ways to strengthen congressional procedures, a full catalogue of which is beyond the scope of this report. They share a common liability, which is that from the executive branch perspective they are all rules of the Congress and subject to change without regard to the presidential veto power. Ultimately, even super-majority rules are controlled by a simple majority.

Providing Remedies

The fourth approach to enforcement would be neutral in its distribution of responsibility between the two branches. This approach is neutral in the sense that the outcomes have been agreed to ahead of time by both branches.

This was the idea behind the sequester process, but it did not work. Key discretionary calculations, after Bowsher v. Synar, became the sole prerogative of the executive branch. Moreover, no matter what causes the deficit target to be exceeded, the sequester was focused on a small portion of the budget—primarily the annually funded domestic and military programs. In addition, the entire process was based on estimates controlled by the executive branch and potentially subject to political manipulation. (As an illustration, an executive branch decision to decrease a forecast of GNP by $60 billion, or 1 percent, could cause a cut in domestic and military appropriations by $10 billion each.) The sequester process could be made more objective and more practical by two changes:

- use actual data, so control of the estimates is not an issue, and
- modify the sequester instrument, so that the causes of overruns are related to the remedies.

A key, however, is that the remedies themselves be enacted into law and be credible. Credible and objective procedures are more likely to provide strong incentives to adhere to a budget agreement initially, rather than trying to correct violations after the fact.

One approach that might provide such incentives would be to enact into law automatic adjustments in tax rates and entitlement benefit payments that would offset revenue shortfalls or expenditure overruns as measured by the actual levels reported by Treasury at the close of the fiscal year. Unanticipated deficit increases due to revenue shortfalls and interest payments or other uncontrollable financial overages, such as deposit insurance and loan defaults, would trigger automatic increases in withholding rates or surtax payments. Entitlement overruns would trigger automatic benefit reductions explicitly authorized by the Congress in advance to make up the shortfall. Faced with the prospect of these corrective actions neither the administration nor the Congress would be inclined to pretend to meet budget targets through optimistic economic assumptions or unrealistic technical estimates. Moreover, legislated benefit increases not anticipated in the budget targets would prove illusory, since they would either be offset or rolled back by this adjustment mechanism.

The use of actual financial data in the enforcement process would force the budget process to pay attention to the bottom line for the first time. Obviously, a truly unanticipated slowdown in the rate of economic growth could, under this scheme, precipitate an unwanted automatic

fiscal response. Given the current technology in making budget calculations, appropriate corrective action could be built into the process without great difficulty. For example, allowances for shortfalls in budget receipts could be included with specific dollar amounts related to major shortfalls in GNP.

A variation of this approach would be to apply the sequester process only to program-related outlays, that is, excluding receipts and interest payments. This could result in less pressure to forecast the deficit accurately (since overages in interest and underruns in receipts would go uncorrected), but it would be a more practical and perhaps more realistic alternative.

If a budget agreement were implemented through statutory outlay caps on individual discretionary appropriations, there may have to be exemptions from existing impoundment control restrictions on the President. This would provide the executive branch more power over spending levels and priorities than is now the case. If agencies were required to comply with outlay caps using only administrative means, it could interject higher costs and substantial inefficiencies in the management of operations.

Budget Reform

The previous chapter discussed mechanisms that might be used to enforce a budget agreement. However, focus on enforcement should not divert attention from the desirability of implementing basic budget reforms. This chapter addresses ways that the budget process could be made more effective and accountable.

Move Beyond Automatic Budgeting

For most of the years of our republic, until the mid-1980s, budgetary outcomes at the federal level essentially reflected the give-and-take of good faith negotiations and compromise—both within the legislative and executive branches and between them. Unfortunately, that changed to a significant degree when the usual procedures were overwhelmed by the fiscal and political strains of the early 1980s. Not only did elected officials face deficits of almost unprecedented peacetime magnitude, they also found themselves increasingly divided over fundamental policy choices.

Presidential budgets were increasingly seen as "dead on arrival" in the Congress, and the Congress itself came under divided party control (Republicans in the Senate, Democrats in the House of Representatives) during the 1981 through 1986 period—the first such divided Congress in 50 years. Furthermore, within each chamber, a fragmentation and duplication of budget-related responsibilities among several kinds of committees and leadership structures created immense coordination problems and contributed to a heavy budget workload that seemed to crowd out other important legislative activities.

In this early 1980s environment of increasing partisanship and divisions, the budget process appeared to be breaking down. Agency officials faced increasing uncertainty as temporary continuing resolutions rather than full-year appropriations provided much of their funding. In the fall of 1984, when neither regular appropriations nor a continuing resolution was passed by the start of the fiscal year, some federal agencies started closing nonessential activities and furloughing employees. Most importantly, no progress was being made in reversing the pattern of annual deficits and an accumulating governmental debt. Over the fiscal years 1981 through 1985, the gross federal debt outstanding doubled, rising to an alarming 46 percent of GNP.

The frustration in Congress over the government's inability to make decisive and disciplined budgetary decisions led to enactment in 1985 of the GRH emergency deficit reduction law, the central features of which were, and are, statutorily set declining annual deficit targets to produce

a balanced budget and a provision for automatic, across-the-board cuts ("sequestration") in the event that a year's regular spending and revenue legislation are not estimated by OMB as achieving that year's deficit target.

In 1985 when the Congress was considering this legislation, we expressed our serious doubts about such a "mechanistic" and "formula" approach to budgeting. The events of the years since enactment of the GRH law have not changed our minds. The bottom line is that 5 years of technical compliance with that law have resulted not in meaningful deficit reduction, but rather in a whole new generation of off budget and other misleading budget reporting practices that hide the true magnitude of the problem. "Cooking the books" has become a way of life in Washington. Placing off budget $30 billion in borrowing for the savings and loan bailout is but one example.

The disappointing fact is that official actions have contradicted the deficit reduction goals set forth in the original GRH legislation. In 1987, the Congress and the President decided that they could not accept the consequences of the existing GRH schedule of declining deficit targets, and they amended the law to extend the target date for a balanced budget by 2 years. At this writing, it appears that another such amendment is likely. Such unwillingness to make the painful revenue and spending choices implied by the GRH legislation has resulted in some sobering numbers: whereas the general fund deficit stood at $266 billion when GRH went into effect, we project in chapter 2 that it will reach almost $400 billion in 1997.

The pattern of gimmickry and stagnation in addressing the deficit points to the inherent weakness of applying technical approaches, such as GRH automatic enforcement mechanisms, to essentially political problems. If there is insufficient underlying political will and capacity for decisive action, such mechanisms, particularly if they would trigger major spending or revenue adjustments, will probably not be either automatic or effective. We believe that improvement in federal budgeting requires more fundamental reforms to enhance the capacity of the legislative and executive branches to reach timely, realistic agreements through good faith negotiations and compromise. We certainly would not recommend, however, simply returning to the laws and conventions of pre-GRH budgeting because they also were flawed and inadequate for sustaining a realistic deficit reduction plan of action. Set forth below are the additional principles that we think should guide efforts to revitalize federal budgeting.

Adopt a Joint Budget Resolution Procedure

For most of our history, budgeting was heavily oriented toward the executive branch. Presidential or agency budget submissions normally framed the debate and the Congress' practice was to play a reactive role and make minor changes. There was also a certain spirit of comity that limited actions, such as an understanding that the President would not impound funds to unilaterally reverse congressional policy decisions.

The Congress became much more assertive in the 1970s in reaction to the President's expanded use of impoundments and public disenchantment with the institution of the presidency arising from the Watergate events. The result was the 1974 Congressional Budget and Impoundment Control Act, which considerably increased the powers of the Congress over budgetary matters. The Congress would henceforth express its own budget policy in an annual "concurrent resolution" on the budget (not requiring Presidential signature), and the President would be prevented from effecting certain impoundments ("rescissions") without explicit congressional approval.

We do not question the basic balance the 1974 act established between the branches over fiscal matters. However, we would suggest replacing the concurrent budget resolution requirement with a "joint resolution" requirement. A joint budget resolution requiring presidential signature would still provide a vehicle for the Congress to express its budget policy while at the same time encouraging earlier budget negotiations between the two branches. It would reflect an inescapable reality—namely, that in the final analysis, budget policy is a joint matter between the branches. Recognizing this reality by requiring a joint budget resolution early in the annual budget cycle would institutionalize the budget summit approach found to be so necessary in recent years.

Expedited Rescission

On a related matter, we think it would be a step forward for the Congress to adopt an "expedited" procedure for considering presidential rescission proposals. Rescission bills would have privileged status and, unless chamber rules are waived, would be quickly brought to the floor for a vote. If the Congress votes for the rescission bill, and the President signs it, the prior budgetary decisions are overturned. If the Congress votes against the bill, or takes no action at all, the prior budgeting decisions are left unchanged. We believe that this procedure, unlike a line-item veto procedure, would not fundamentally alter the Congress' and the President's roles. Expediting consideration of the President's rescission proposals is appropriate in today's budgetary environment of

omnibus spending legislation in which individual items often receive little or no attention during initial passage.

Institute Meaningful Multiyear Budget Planning

The current budget deficit problem has been years in the making and will require years to solve. Bringing the level and mix of defense spending into line with new realities and adopting and carrying out a sounder health care strategy are but two examples of the underlying problems or challenges requiring actions over several years. For such efforts, the government needs a sound multiyear budget planning process, one it does not have.

Although the current GRH law's set of declining budget deficit targets is a multiyear budget plan agreed to by the President and the Congress, the first of its kind in federal budgeting, it suffers from a fundamental defect. It is a static plan and it relates to only one number, the total deficit. The assumption behind this piece of "emergency"[1] legislation is that a one-time plan of fixed deficit targets will suffice. Experience since enactment of that law demonstrates the fallacy of that assumption. The targets have been changed once and will undoubtedly be changed again. Multiyear budget planning in a government such as ours should be an integral part of the normal budget process. Joint executive-legislative plans on broad categories of the budget should be regularly developed and revised in that process, which is not being done at this time. The appropriate vehicle for setting forth an executive-legislative plan and periodically revising it as needed would be a joint budget resolution covering a multiyear period. In the context of the 6-year deficit reduction program suggested in this report, we believe a 6-year resolution would be appropriate. However, a 5-year resolution would also be feasible, in expectation that the 5-year plan could pick up additional years of any extended strategy as part of subsequent revisions.

While any such plan would surely have to be adjusted from time to time to reflect changing circumstances, there would have to be some discipline in carrying out the approved plan. Departures from the plan should flow from fully debated changes approved in the joint budget resolution process itself rather than from individual bill actions that violate the terms of the plan. To help provide this discipline, existing congressional budget process legislation should be amended to require

[1]The law's official title is the "Balanced Budget and Emergency Deficit Control Act of 1985" [Emphasis added].

budget reconciliation for each of the budget plan years.[2] This would minimize the likelihood of adopting plans that lack force because of incomplete follow-up legislation, a situation that occurred last year when the Senate adopted a concurrent budget resolution covering 3 years but passed reconciliation legislation covering only the first of those years. It would also be advisable for the Congress to adopt points-of-order against committee or subcommittee actions that exceed section 302 allocations for years beyond the coming fiscal year.[3]

The Congress should also review the layering of functions and committees that has the effect of complicating procedures and lessening budgetary discipline. Over the past decade, several congressional study groups or individual Members have examined these matters and produced assorted recommendations, including recommendations for better integrating congressional leadership and the committees involved in budgeting. We think it is time for the Congress to take up the various proposals and adopt appropriate changes. We recognize that such reforms are not easy to make but believe that they are necessary if the Congress is to operate more effectively on budget-related matters.

A successful joint resolution process resulting in realistic, multiyear plans could go a long way toward satisfying the principal objective of biennial budgeting proponents, which is to free up time for nonbudgetary business in the Congress and the executive branch. The November 1987 budget summit agreement covering fiscal years 1988 and 1989 showed this potential. That agreement for fiscal year 1989 paved the way for the least contentious and time-consuming budget cycle in years, allowing all of the major appropriations bills for that year to be passed on time—the first such timely completion in 12 years.

Improve the Budget's Numbers

It is difficult to see how substantial and lasting progress can be made on getting the budget under control when there exists so much doubt and confusion over the "actual" and projected amounts reported in the budget. The problem runs deeper than "cooking the books." It goes to

[2]"Reconciliation" in the Congress is the process of passing a package of non-appropriations legislation to alter spending and revenue levels. The largest spending amounts affected by reconciliation pertain to entitlement programs, such as Medicare.

[3]Section 302 of the 1974 Congressional Budget Act provides for allocations, as part of adopting a budget reduction, to committees and subcommittees of the budget resolution's approved spending totals. When spending legislation exceeds the allocations, budget discipline can be undermined. Under current House and Senate procedures, points-of-order may be laid against such reported bills to enforce allocations for the coming fiscal year, but not the years beyond that.

the very core of the budget measurement concepts that are used. The budget's almost exclusive focus on immediate cash transactions means that decisionmakers often make commitments that will create future obligations without recognizing the full costs of these programs. Thus decisionmakers are frequently faced with surprises when forced to pay bills that come due without warning, and they spend inordinate time and effort trying to find ways to finance commitments made years ago but never adequately funded.

A current and striking example is the hundreds of billions of dollars that Americans must pay for the savings and loan bailout. The total could easily reach $500 billion! These costs were not incurred overnight but grew over a period of years. Yet the liability became an overriding concern only when the government began spending cash to resolve insolvent thrifts. A similar example is the practice of treating new loan guarantees, now running at about $100 billion annually, as cost free because they involve no cash outlays in the first year. In reality, they could entail substantial future costs because of defaults.

Some progress has been made in recent years to correct these weaknesses in the budget. For example, pensions for military personnel are now accrued in the budget, as are pensions for civilian employees hired since 1984. However, the costs for many programs remain understated in the current budget. Thus we recommend the adoption of full accrual reporting as a necessary part (along with reported cash outlays and receipts) of sound budgeting. The Congress and the President will continue to be faced with budget surprises in the absence of accrual budgeting, which was recommended in 1955 by the second Hoover Commission and in 1967 by the President's Commission on Budget Concepts.

We strongly recommend that the budget process recognize the full costs of programs when policy initiatives or events in the economy create the likelihood or certainty of future program payments. This would include estimating the expected losses on proposed direct loans, loan guarantees, and insurance claims and obtaining appropriations to cover these costs before program commitments are made. The administration, the Senate and House Budget Committees, CBO, and GAO have all proposed credit budgeting reform along these lines, and we recommend prompt enactment of legislation to accomplish this reform.

The budget should also begin to accrue all retirement benefits earned by military and civilian workers, including health benefits. Failure to accrue these costs causes total operating expenses to be significantly

understated. Similarly, recognizing budget costs for federal payroll and similar liabilities as they are incurred would eliminate the incentive to claim budget "savings" by shifting paydays from one fiscal year to another. Using billions of dollars worth of agricultural payment-in-kind certificates and similar credits in lieu of cash should also be included in budgetary totals to close this emerging form of backdoor spending.

We recognize that full accrual budgeting cannot be implemented immediately because estimates of many of these accruals need to be developed. However, accruals should be phased in as principles are adopted and reliable data are generated. Until then, preliminary estimates should be presented and discussed in supplementary budget materials.

In addition, the budget should include a broader statement of the government's contingent liabilities that goes beyond data currently provided. It would also be useful to have a summary statement of unmet needs that are not yet embodied in legislation or proposed in the budget because of fiscal constraints.

Change the Unified Budget

The federal government's adoption of a unified budget for fiscal year 1969 marked a major advance in the way the government presented its budget plan and accounted for its revenues and expenditures. The need for a unified budget remains as strong today as it was in 1969. This does not mean, however, that there are no problems with the structure of the current budget. There definitely are, as new policy and fiscal issues have arisen that were not anticipated when the budget's current structure was adopted 20 years ago. As explained below, the present budget structure's exclusive focus on a single, bottom-line cash deficit obscures important differences among programs and makes it difficult for the public and many officials to understand what is actually going on in the government's finances.

Major Problems in the Unified Budget's Treatment of Trust Funds

Since 1969, the budget's annual surplus or deficit has reflected the combined results of trust and general revenues and expenditures. At the time the unified budget was adopted, it was not anticipated that the trust funds would soon accumulate large annual surpluses, but that is exactly what happened in the 1980s as a result of conscious policy choices to build large reserves in the retirement programs, principally Social Security and the pension plans for federal civilian and military employees.

As discussed in earlier sections of this report, the growth in trust fund surpluses in recent years has masked the fact that the general fund deficit has also been growing. The focus on the unified budget deficit has forestalled action to reduce the general fund deficit, thereby undermining the economic purpose for accumulating trust fund reserves.

A restructured budget with a separate trust fund section and subtotal for the retirement trust funds (and other trust funds where reserves are accumulated for liabilities to make future payments) would focus attention on the general fund deficit and be consistent with a strategy of using the trust fund surpluses to restore domestic savings to more adequate levels. The goal of that strategy should be to achieve over time an approximate balance of revenues and expenditures in the general fund.

Serious Shortcomings in the Unified Budget's Treatment of Enterprise Programs

The budget is not organized in a way that facilitates tailoring budgetary decisions to the special needs of the government's business-type entities. These enterprises, such as the Postal Service and Tennessee Valley Authority with programs costing about $40 billion and $6 billion a year, respectively, have several characteristics which distinguish them from other government activities. They

- sell a product or service to the general public,
- are established to be self-financed for the most part by fees paid by users of the product or service, and
- have expenses which fluctuate with consumer demand.

If an enterprise-type activity is to operate successfully as a business, it needs more flexibility than some government programs. For example, it needs to be able to set its user fees to recover its operational costs. Also, it must be able to make relatively independent investment decisions to plan for and react to changes in consumer demand. While it would be appropriate to treat enterprises differently than other programs, the provisions of GRH and related budget legislation apply equally to enterprise investments and other government activities. Recently, for example, the Postal Service was required to reduce the hours of window service in local post offices in order to contribute to overall deficit reduction efforts. Actions such as this one, if perpetuated, would be counterproductive and undermine the Postal Service's capacity to provide efficient service to the public, discourage patronage, and threaten the Service's ability to cover its costs.

The problems discussed above partly explain the periodic efforts by the Congress or the administration to remove federal programs like the Postal Service from the budget. The incentives to remove these programs from the budget would be lessened by a restructured budget more relevant to the government's current and future needs. This is why we also propose a budget with separate sections and subtotals for enterprise activities.

The Unified Budget Does Not Handle Investment Programs Properly

The focus on a single deficit total does not distinguish between operating deficits and capital financing requirements. This is misleading and has resulted in an unsound GRH deficit reduction strategy which does not distinguish in its deficit goals between the $155 billion spent on capital investments and the $1.2 trillion for operating expenses in fiscal year 1989. These two kinds of spending are not the same. Capital investments, unlike operating expenses, produce assets that generate future streams of benefits to the government or economy. The benefits may be in the form of cash, facilities that can be used over several years, or other economic returns.

This federal budget focus on a single deficit total differs from that seen in many states which practice capital budgeting. At least 37 states use a capital budget, either as part of a comprehensive budget or as a separate budget. Recognizing that capital investment is different from operating expenses, most of the 34 states with balanced budget requirements target those requirements only to their operating budgets. Debt financing is used for their capital projects, subject to separate state debt limits. Further, the states control their debt by requiring their annual debt service costs to be included in the operating budgets and thus subject to balanced budget requirements.

The current budget also creates a budget bias against capital investment programs. Because the budget does not annualize the costs of capital projects, a proposed new investment appears more costly, on a yearly basis, than it really is. Under the present budget rules, a $50 million outlay to construct a hydroelectric plant (a capital investment) in a given year contributes to the year's deficit just as a $50 million outlay for vehicle or airplane fuel costs (an operating expense) does. However, the full $50 million in federal assets has not been used up. Only the cost of using the hydroelectric plant for the year—$2 million if the plant has a 25-year life—is a true cost for that year. This budget treatment often

leads to uneconomical decisions. For example, decisionmakers frequently decide to forgo the construction of a facility because of the sizable, initial cash outlays that would be reflected in the budget and choose instead another option for space acquisition—leasing—with lower initial budget impact but higher long-term costs.

The costs of direct loan programs (another type of capital investment) are also distorted because the budget does not reflect the fact that in making a loan, the government receives a financial asset and that at least a portion of the loan outlays will be repaid in the future. Under current budget treatment, a portfolio of $100 million in new direct loan outlays counts toward the deficit the same as $100 million in grants, even though some of the loans will be repaid in the future. This problem would be corrected by the credit budget reform legislation discussed earlier in this chapter.

An argument can also be made for including expenditures for human development, such as education and training, in the definition of capital. However, substantial disagreement exists about the definition of human capital and how to depreciate these expenditures correctly. This issue needs to be dealt with and resolved before capital budgeting can be fully implemented. In the meantime, capital budgeting can be adopted in stages. A logical progression would be to first include financial capital (direct loans) in a capital budget and then expand the concept to cover physical and human capital as definitional questions are resolved. These delays should not, however, delay restructuring of the budget into general, trust, and enterprise components.

Our proposal, therefore, also includes the notion of dividing the general, trust, and enterprise sections of a newly-restructured budget into operating and capital parts. Table 9.1 shows fiscal year 1989 budget results restructured along these lines.

Table 9.1: Restructured Federal Budget for Fiscal Year 1989

Dollars in billions

	Total	General	Trust[a]	Enterprise
Operating surplus/deficit(-)	$−123	$−259	$142	$−6
Capital financing requirements	−29	−25	0	−4
Unified budget financing requirements	$−152	$−284	$142	$−10

[a]The trust fund category includes only the trust funds in which revenues are earmarked to finance entitlement benefits. Other trust funds, in which revenues are earmarked to finance other activities but spending is controlled by annual appropriations, are included in the general fund category along with other discretionary spending.

The above framework could easily be adapted to incorporate as subcategories the parts of any budget agreement between the executive and legislative branches, such as defense, entitlements, and nondefense discretionary activities.

Other Matters for a Budget Commission

The reforms we have suggested in this chapter would not entail fundamental changes in institutional roles or raise constitutional questions. However, there are other proposals that would, namely proposals for a balanced budget amendment to the Constitution or a line-item veto (or enhanced rescission powers) for the President. We would strongly advise against further action on such proposals until they have been studied carefully by a high-level, bipartisan study group modeled on the 1967 President's Commission on Budget Concepts. The implications of such proposals are complex and imperfectly understood at this time, and possible changes of this nature should be weighed carefully for their long-term effects on our system of government.

Better Management of the Government Is Essential

The changes in fiscal policy discussed in chapters 3 through 7 are logically complemented by the discussion of possible budget process changes in chapters 8 and 9. In addition, however, we need better management of whatever resources are allocated to carry out functions in the public sector.

Many Americans have come to believe that all that is necessary to eliminate the deficit is more efficiency in managing government operations. Improved efficiency alone is not the answer and, more often than not, will also involve increased investment. However, improving management of the government's operations—including our $1.2 trillion annual budget and our trillions of dollars in assets, revenues, and debt—can make an important contribution toward reducing the deficit.

Tens of billions of dollars can be saved annually by heightening attention to controls, increasing the focus on longer term planning, and improving the flow of management information. We have estimated that in recent years, problems in these areas have had a cumulative cost of between $100 and $200 billion, excluding losses associated with the savings and loan bailout. These problems also undermine confidence in the government and fuel skepticism about legitimate needs to raise revenues and make sacrifices for critical program expenditures.

Experience has demonstrated the difficulty of capturing increased efficiency in the form of reduced spending. But that is not the only consideration. Management improvements may free up resources to be used for better purposes or may translate into better performance. Regardless of how they are eventually reflected in the budget, management improvements are essential in an era of constrained resources.

Inattention to Management Controls Has Proven Extremely Costly

Appointed public officials tend to be preoccupied with developing policies, not managing programs. Consequently, management controls often are not in place or do not work properly. A few illustrations of the consequences follow.

- Over $34 billion of DOD's $100 billion in inventories is unneeded. Elimination of this unneeded inventory through better systems and controls would reduce carrying costs (obsolescence, warehousing, and interest) alone by several billion dollars per year.
- Over $100 billion is expected to be paid out in fiscal year 1990 to over 33 million Medicare beneficiaries. Cutbacks in payment safeguards and

claims processing activities could result in over $1 billion in erroneous benefit payments.

- Problems in managing accounts receivable recorded by IRS in excess of $60 billion place IRS in the forefront of agencies needing improved systems. Better management systems could speed up the resolution of disputed collections in past due accounts.

The 1982 Federal Managers' Financial Integrity Act was supposed to be a key management tool for uncovering and dealing with such weaknesses. The act requires heads of federal agencies to annually assess controls over their operations and provide reports to the President and the Congress on actions taken to correct major problems. This law has stimulated some agency improvements, primarily in identifying problems areas, but our reports have shown that efforts to date clearly have not produced the results intended by the Congress.[1] Critical problems remain and more concerted effort is needed by the executive branch to implement the act. To help foster such actions, we have undertaken a special effort targeted at 14 of over 100 high-risk areas most likely to result in large losses and unnecessary costs.

Approach to Decision-making Does Not Lead to Efficient Use of Resources

Federal leaders make too many decisions without adequate information and without an understanding of long-term implications. This sometimes results in poor decisions which cost the nation much more than necessary.

Several recent catastrophes and lingering dilemmas underscore the serious consequences of this approach to decision-making.

- One cause of the savings and loan debacle was the government's failure, in deregulating the industry, to require proper accounting by the thrifts and to invest in adequate supervision over the industry's greater lending latitude.
- A long-standing emphasis on production over maintenance has contributed to severe operational and related environmental problems in the country's nuclear weapons complex. Fixing this problem is estimated to cost over $100 billion over the life of the effort.
- DOD's 5-year defense plan is still not linked to budget plans. This discontinuity leads to inefficiencies and wasted efforts.

[1] Financial Integrity Act: Inadequate Controls Result in Ineffective Federal Programs and Billions in Losses (GAO/AFMD-90-10, November 28, 1989).

Information Is a Key Factor

The government's ability to address its management control needs and make informed decisions is constrained by a lack of reliable, timely data. Examples include the following:

- The fact that the government had over $5 trillion in exposure on loans, insurance, and other risk-related programs came as a surprise to many top federal officials, despite the fact that data related to this exposure have been included in supplemental budget materials for many years. Governmentwide accounting and its integration into policy-making for contingent liabilities of all sorts are still inadequate.
- Only about one third of government outlays are covered in audited financial statements. Audits show that agencies often report information which is materially inaccurate. For example, Air Force reports to OMB and Treasury have contained tens of billions of dollars in inaccuracies.
- Accounting systems in government agencies do not provide adequate information necessary for efficient day-to-day management; for example, effective cost accounting systems do not exist.

Major Improvements in Federal Management Are Needed

The government has had a variety of programs, initiatives, and other endeavors to improve federal management controls, planning efforts, and accounting systems. However, these efforts have a long way to go before they are effective, and additional initiatives are needed. The problems mentioned here continue to impact a broad range of government programs and operations and touch every major federal agency.

Better management of the government is potentially a part of deficit reduction—it can reduce the baseline deficit by reducing unnecessary costs and losses now reflected therein. For example, carrying costs of unneeded inventories can be taken out of the DOD segment of the baseline without affecting programs. More importantly, better management can help prevent future increases in the baseline by avoiding the repetition of savings and loan type problems. Without needed management improvements, there is a real possibility of having to adopt even more revenue increases or cost reduction measures to achieve the targeted budget surplus because of unknown future events and costs.

Better management in the government, however, will require an improved workforce, institutional change, intensified oversight on the part of OMB and the Congress, and better long-range planning.

Ways must be found to provide the compensation necessary to attract the highly skilled technical people needed to supervise systems improvement projects and scientific initiatives. In some areas, government training efforts are woefully deficient. More skilled people at all levels are needed to improve controls, planning and information.

Institutional changes in the approach to federal management, especially in the financial management arena, will be required to sustain the attention and continuity of effort necessary to achieve better controls and systems in government programs. For example, the federal government does not have a legislatively established chief financial officer (CFO).

We urge the Congress to enact legislation to

- establish a chief financial officer structure for the federal government, with a CFO for the United States, counterpart CFOs in each of the major agencies, and supporting personnel to provide continuity when political leadership changes; and
- require the annual preparation and audit of agency financial statements and an oversight report to the President and the Congress containing the annual financial statements, audit report, evaluations of controls and agency compliance with laws and regulations, a summary of the Financial Integrity Act report including corrective actions taken, and other information concerning an agency's financial management.

A legislatively mandated CFO would be responsible for developing and implementing a long-range governmentwide financial management improvement plan which would address both systems and controls. A CFO structure of the kind recommended would help give financial management the prominence, permanence, and continuity necessary to achieve reform and enable the government to better manage its financial affairs.

Requiring the annual preparation and audit of agency financial statements is another essential part of the solution. We find major problems with the accuracy of the financial information and supporting systems whenever financial audits of federal agencies are performed. For example, an audit of the Federal Housing Administration's fiscal year 1988 financial statements showed a loss of about $4.2 billion which was almost five times the amount the agency initially reported. What does that say about its systems and controls?

Preparing auditable financial statements demonstrates that an organization's financial systems and personnel are capable of accumulating, analyzing, summarizing, and reporting on its financial condition and operating results. An inability to do that means there are serious weaknesses in the organization's systems and controls. The knowledge of problems is an essential prerequisite to solving them.

OMB can improve agency response to needed improvements in systems and controls by linking the Financial Integrity Act internal control review process to the budget. We also believe that the Congress, through its committees, should hold annual hearings using the oversight report as the focal point in the process of reviewing agency actions to correct control and systems weaknesses. The Congress, through such hearings, could insure that proper corrective measures are actually implemented.

Finally, substantial improvements in government long-range planning are also needed to manage the deficit reduction plan suggested in this report. The Congress and the administration must have an improved ability to see ahead. Financial management improvements we have sought, including reliable financial statements, will provide the essential historical and factual information for this planning process that is not now available. The agencies' ability to look ahead, as well as OMB budget planning, is hampered by the lack of reliable and comprehensive data on costs, commitments, and contingencies. More emphasis on the long range planning process by government managers is also needed. The difficulties in estimating the future costs of the savings and loan crisis are but one example our nation's inadequate planning efforts, just as the very existence of that crisis exemplifies inadequate governmental policy-making and management.

Letters From Congressional Requesters

Letter From Senators Exon and Grassley

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ARMED SERVICES
COMMERCE, SCIENCE, AND TRANSPORTATION
BUDGET

United States Senate
WASHINGTON, DC 20510-2702

May 22, 1990

Charles A. Bowsher
Comptroller General of the United States
General Accounting Office
441 G Street
Washington, DC 20548

Dear Mr. Bowsher:

We are increasingly concerned about the implications of the budget deficit. It is essential that Congress and the President reach agreement on an appropriate long-term fiscal policy for the nation and that we put the budget on a sustainable path toward that goal. Because of our concern, which we know you share, we would like to enlist the resources of the General Accounting Office in an effort to lay out the key choices for Congress and the American people.

We are asking for this assistance not only because of the GAO's well-established reputation for integrity and objectivity, but also because of its extensive knowledge, gained through many years of audits and evaluations, of the details of the programs and policies that must be changed if we are to put our financial house in order.

We ask your advice and analysis in the following areas:

1. What is your best estimate of the debt and current path of the deficit absent aggressive efforts to reduce the deficit?

2. What should be our long-term budget goal? That is, should we aim for balance in the unified budget or for some other target?

3. How rapidly should we seek to reach that goal, considering the potential effects of deficit reduction on the economy and a realistic assessment of the speed with which federal programs can adapt to changes in available budgetary resources?

4. How should we judge the relative merits of increased taxes and reduced spending as ways to reduce the deficit?

5. How should we deal with unavoidable, but so far unfunded costs (such as those associated with the savings and loan situation), and other pressures to increase spending in response to unmet needs that you have identified in recent reports and testimony?

6. Are there any areas of deficit reduction which the Congress and the President have overlooked which could provide significant savings?

7. What is the range of choices we should consider in seeking to achieve an appropriate rate of progress in reducing the deficit? Please identify several alternative deficit reduction strategies, including one showing how we could cut spending enough to achieve an appropriate pace of deficit reduction without additional taxes, and others showing how the picture changes with various forms and levels of additional taxation.

8. How should the presentation of the budget be changed to convey the problems and choices better to Congress and the taxpayer?

9. What other changes in budget concepts and practices are needed if we are to put the budget on the appropriate track and keep it there? Please discuss reform of the budget treatment of credit programs and suggest any incentives that might encourage the collection of debts owed the government and the disposal of unneeded assets, while at the same time avoiding the risk of improper manipulation of budget estimates.

We recognize that the development of revenue and outlay estimates needed for various parts of the analysis would be greatly helped by assistance from the Congressional Budget Office and the staff of the Joint Committee on Taxation. Accordingly, by copy of this letter, we are requesting Director Reischauer of CBO and Chief of Staff Pearlman of the Joint Committee to provide you such assistance as you may need, to the extent feasible consistent with their other responsibilities.

Anticipating that Congress will be concentrating on the budget in September, we would appreciate a report on these issues, including such recommendations as you may deem appropriate, that would be available when Congress returns from the August recess. We have no objection to your sharing with others, on an informal basis, information developed in response to this request as the work proceeds and to your making the report publicly available immediately upon delivery to us.

Charles Bowsher
May 22, 1990
page three

This request has been the subject of discussions between Assistant Comptroller General Harry Havens and other members of your staff and Mr. Christopher McLean of Senator Exon's staff and Mr. Kim Kolesnik of Senator Grassley's staff. Please contact Mr. McLean or Mr. Kolesnik if further discussions are necessary and to keep us advised of progress in the work.

Thank you for your assistance.

Sincerely,

Charles Grassley
United States Senator

Jim Exon
United States Senator

Letter From Senator Moynihan

Daniel P. Moynihan
New York

United States Senate
Washington, D. C.

June 21, 1990

Dear Mr. Bowsher:

I have learned of the study that Senators Exon and Grassley have requested you to perform concerning the outlook for the budget deficit, the fiscal policy that the nation should be pursuing, and the options to get us there.

As you know, I am much concerned about these issues. And, because of my responsibilities as chairman of the Subcommittee on Social Security and Family Policy of the Senate Committee on Finance, I have had a particular concern about the misuse of the Social Security Trust Funds. Accordingly, I would like to join in requesting the study proposed by Senator Exon and Grassley. I also will support their request to Ron Pearlman of the Joint Committee on Taxation for such assistance as you may need.

Let me know how else to support your efforts.

Sincerely,

The Honorable Charles Bowsher
General Accounting Office
Washington, DC 20548

Letter From Senator Bradley

BILL BRADLEY
NEW JERSEY

United States Senate
WASHINGTON, DC 20510

July 24, 1990

The Honorable
Charles A. Bowsher
Comptroller General of the United States
General Accounting Office
Washington, D.C. 20548

Dear Mr. Bowsher: Mr Bowsher

I have learned of the study that Senators Exon and Grassley have requested you to perform concerning the outlook for the federal budget deficit, the appropriate fiscal policy that the Nation should be pursuing, and alternative strategies for moving toward that goal.

As you know from our private conversations, I am deeply concerned about these issues because of their implications for the future of our Nation's economy. In addition, of course, these matters have an important bearing on my responsibilities as a member of the Senate Committee on Finance. Accordingly, I would like to join in requesting the study proposed by Senators Exon and Grassely. I also endorse their request to Chief of Staff Pearlman of the Joint Committee on Taxation that the staff of the Joint Committee provide such assistance as you may need, to the extent feasible consistent with their other responsibilities.

I would like to be kept informed of the progress of the study and to receive a copy of the resulting report as soon as it is available.

Sincerely,

Bill Bradley

BB/kaa

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