Statement of Robert D. Reischauer*

Joint Economic Committee

June 22, 1995

Mr. Chairman and members of the Committee, I appreciate this opportunity to discuss with you the effort that is now underway to balance the federal budget. The President's speech on June 13 was a significant and constructive contribution to this effort. The President and the leadership in the Congress now have reached agreement on what the nation's basic fiscal policy objective should be---namely, to balance the federal budget by a set date in the not-too-distant future. Notwithstanding this consensus about the objective, significant differences remain between the President and the leadership in the Congress concerning the magnitude of the underlying problem, the amount of time that should be taken to resolve it, and the specific measures that should be pursued to achieve budgetary balance. While the rest of my statement elaborates on these differences, the primary message that I would like to convey to you is that these disagreements should not be allowed to derail this historic opportunity to enact legislation that substantially reduces the deficit.

*How Big is the Problem?*

The major difference between the President's and the Congress' budget balancing plans is the size of the deficit that each is attempting to eliminate. The Congress' view of the problem is based on the Congressional Budget Office's (CBO's) baseline budget

* Senior Fellow, The Brookings Institution. The views expressed in this statement are those of the author and should not be attributed to the staff, officers or trustees of the Brookings Institution.

projections. These projections, which assume no changes in policy and adherence to the discretionary spending caps through fiscal year 1998, show the deficit growing steadily and rapidly over the next ten years. CBO projects that the deficit will rise from $175 billion in fiscal year 1995 to $349 billion in 2002 and to $472 billion in 2005 (See Chart 1). As a fraction of GDP, CBO sees the deficit rising from 2.5 percent in 1995 to 3.5 percent in 2002 and to 4.1 percent in 2005. The rapid rise in the baseline deficit means that the task of balancing the budget does not become any easier if it is stretched out over a longer period of time.

The President's budget balancing plan is based on the Office of Management and Budget's (OMB's) projections of the baseline deficit. Like those of CBO, OMB's projections assume no policy changes and adherence to the discretionary spending caps through fiscal year 1998. While OMB projects the baseline deficit to rise after 1995, the increases are quite modest, from $193 billion in fiscal year 1995 to $240 billion in 2002 and to $266 billion in 2005 (See Chart 1). Compared to OMB's estimates of GDP, the baseline deficit is projected to shrink modestly over the next decade, from 2.7 percent in 1995 to 2.3 percent in 2002 and to 2.2 percent in 2005. Because OMB's projected baseline deficits do not grow in real terms and shrink relative to the size of the economy, the task of balancing the budget becomes easier the longer the period of time taken to eliminate the deficit.

The differences between CBO's and OMB's baseline deficit estimates, which amount to some $206 billion by 2005 (See Chart 2), are the result of different economic and program or technical assumptions. OMB expects nominal GDP to grow, on average, at a slightly faster rate over the next decade than does CBO. As a result, its estimate of nominal GDP in 2005 is about three and one-quarter percent larger than that of CBO. The differences in nominal GDP reflect OMB's higher estimates of both real economic growth and the increase in the GDP deflator. Considering the inherent uncertainty in economic forecasting, these differences are quite small. For example, after 1996 OMB expects real GDP to grow each year only 0.1 or 0.2 percentage points faster than does CBO. As a result of its higher estimate of nominal economic growth and differences in other technical assumptions, OMB's projection of baseline revenues for 2005 is about $67 billion higher than that of CBO (See Chart 2).

OMB also assumes that the CPI will increase at a rate that is between 0.2 to 0.3 percentage points slower each year than the rate assumed by CBO. Slower CPI growth translates into lower baseline costs for indexed benefit programs. Consistent with its view of economic growth, OMB also assumes a slightly lower unemployment rate than does CBO. This difference translates into somewhat lower spending on unemployment compensation and other entitlement programs that are sensitive to the level of joblessness. Altogether, OMB projects spending on the non-medical mandatory programs to be about $33 billion less than does CBO in 2005.

Because both CBO and OMB use the CPI to inflate discretionary spending after the caps expire in fiscal year 1998, CBO's assumption that the CPI will grow at a faster rate contributes to its $20 billion higher estimate of baseline discretionary spending in 2005.

Not all of the differences between OMB's and CBO's economic assumptions lower the Administration's baseline deficit path relative to that of CBO. The Administration's long and short-term interest rate assumptions are generally a few tenths of a percentage point higher than those of CBO. Nevertheless, OMB's estimates of baseline net interest costs fall below those of CBO by 2002 because its lower baseline deficit path results in less debt. By 2005, the difference between CBO's and OMB's baseline net interest estimates is some $34 billion.

The most notable program differences between OMB's and CBO's baseline projections are in Medicare and Medicaid. While CBO anticipates that Medicare spending, net of Part B premiums, will grow at an average rate of 10.3 percent over the next decade, the Health Care Financing Administration's (HCFA) estimates, which OMB incorporates into its baseline projections, anticipate an average growth rate of 9.8 percent per year. The differences with respect to Medicaid are a bit larger; CBO anticipates an average growth rate of 10.0 percent while HCFA expects Medicaid spending to rise by 9.2 percent a year. Over the course of a decade, these modest differences compound so that by 2005 OMB's baseline estimate of Medicare spending is some $32 billion below that of CBO and its estimate of Medicaid outlays is $20 billion below CBO's.

The large gap between CBO's estimate of the baseline deficit that must be eliminated to balance the budget and OMB's estimate of the problem raises the question, "Which estimate is likely to be more accurate?" The simple answer to that question is that no one knows. The methodologies used to generate the long-run baseline budget projections are necessarily crude. The uncertainty that surrounds the likely course of the economy five to ten years from now is great. Furthermore, if the past is any guide, unexpected surges and slowdowns in entitlement program spending are likely to occur in the future.

Some critics have suggested that the Administration has relied on excessively optimistic economic assumptions for its baseline budget projections---that Rosy Scenario's younger sister is making her debut. This charge is unwarranted. OMB's economic assumptions for the 1995 to 2000 period are not significantly different from those of the Blue Chip Consensus and are less optimistic than those of a number of private forecasters. Compared to the projections made by the few forecasters who have the nerve to predict the course of the economy past 2000, the Administration's assumptions shade toward the optimistic, but are well within the bounds of the possible.

When compared to the differences that existed through much of the 1980s, the differences between OMB's and CBO's views of the economy are quite modest. For example, between 1982 and 1991 the average percentage gap between OMB's and CBO's forecasts for real GDP after five years was 5.6 percent, over four times larger than the difference that exists between the two agencies' current real growth projections after a decade.

A recent revision by CBO has reduced one of the differences between CBO's and OMB's baseline economic assumptions. In estimates made for the budget committees, CBO has incorporated a 0.2 reduction in its estimate of the increase in the CPI after 1998 to reflect the likely effect of re-benchmarking the CPI to the consumption patterns of the 1993-1995 period. CBO has estimated that this change reduces the $206 billion gap between the two agencies' deficit estimates for 2005 by $18 billion.

While OMB's economic assumptions should not be viewed as a flight of unbridled optimism, neither should CBO's assumptions be viewed as excessively pessimistic. CBO's stable interest rate assumptions may be too benign. With the baseline federal deficit rising as a percent of GDP, it might be more reasonable to expect that the increased pressure on credit markets would push rates up a bit. Furthermore, while the CBO projections could accommodate a mild recession at some point during the next decade, a more realistic assumption might be to anticipate two mild recessions or one more severe downturn.

The program assumptions are inherently even more uncertain than the economic assumptions. The future course of entitlement spending, which has been the wild card in recent years, will depend not only on demographic developments and the strength of the economy, but also on the political climates in the states, court rulings, and changes in the private health care market. CBO's assumptions about the growth of Medicaid and AFDC implicitly assume that states will be able to find substantial resources for their matching shares. If states find themselves under severe budgetary pressure, state matching funds may not be forthcoming and, as a consequence, federal costs may not grow as rapidly as CBO expects. The same result would occur if the political climate in the states demands further retrenchment of welfare programs. Alternatively, the innovations some states are making under the Section 1115 waivers to broaden Medicaid coverage and place beneficiaries in managed care systems may prove to be very popular with the voters. If that is the case, states may decide to expand Medicaid coverage to the limit and CBO's projections of federal costs could prove to be too low.

Baseline Medicare spending will be affected by developments in private health care markets which are notoriously difficult to predict. The managed care revolution that is sweeping through employer-sponsored insurance markets could lead to an excess of providers which might put downward pressure on prices. This could result in lower update factors for Medicare hospital and physician payments than is now anticipated in the baseline projections. Alternatively, providers struggling to maintain their incomes in a world that is increasingly dominated by capitated payment arrangements, may turn to Medicare patients to supplement their incomes. While Medicare's volume performance standards and utilization reviews will limit their ability to increase utilization, some increased volume pressure would not be surprising. DRG code creep could also become a more serious problem than either CBO or HCFA anticipates.

Whether OMB's 9.8 percent average Medicare growth rate or CBO's 10.3 percent rate proves to be more accurate will also depend on the course of technology---on the diagnostic tools, surgical procedures, treatments, and pharmaceuticals that will be developed over the next ten years and on the costs of these innovations. We can only speculate about such developments.

Considering the substantial uncertainty that surrounds the size of the deficits that will occur five to ten years from now if policies are left unchanged, which definition of the underlying problem should the Congress use as it formulates its budget plans? Prudence suggests that the Congress should stick with the CBO estimates of the size of the problem if it believes that it is important that the budget plan it adopts be viewed as one with a reasonable, but by no means certain, chance of eliminating the deficit by the target year. As has been true in the past, unexpected and unforeseeable developments will buffet federal spending and revenues. If history is any guide, these surprises will worsen, not improve, the deficit outlook more often than not. For this reason, starting from the more cautious set of projections represents the most prudent course. If CBO's estimate of the size of the problem proves to be too pessimistic, the retrenchment called for in the final years of the plan could easily be scaled back, tax cuts could be provided, or we could enjoy the first budget surplus since fiscal year 1969.

*How Long Should the Budget Balancing Effort Take?*

The second major difference between the President's plan to balance the budget and the approach embodied in the Congressional Budget Resolution is the length of time it takes to erase the deficit. The President would eliminate the deficit over a ten year period while the Budget Resolution's plan would get the job done in seven years. As I pointed out before, under the Administration's baseline deficit path, the task becomes easier if the period is stretched out; under the CBO deficit path, that is not the case.

Three factors should be considered when deciding how long to take to balance the budget. The first is the risk that the fiscal restraint associated with the effort poses for continued growth of the economy. The second is the possibility that sharp spending cutbacks could impose undesirable hardship on vulnerable groups and institutions. The third is that the effort might lose credibility if it is dragged out over too long a period of time.

Unavoidably, the spending cuts associated with both the President's plan to balance the budget and the Budget Resolution's plan will impose some fiscal restraint on the economy. But the magnitude of this restraint is quite modest. The change in the primary deficit as a percent of potential GDP---an accepted measure of fiscal restraint---does not reach 0.6 percent in any year under the various plans. In most years, this measure is below 0.3 percent. Whatever contractionary effects this modest dose of restraint might have, much if not all of it could be offset by easier monetary policy. The retrenchment should cause interest rates to fall somewhat which will stimulate private investment and purchases of consumer durables. Net exports should strengthen with a weaker dollar. In addition, the Federal Reserve could take actions to lower rates further. In short, whether the deficit is eliminated in seven or ten years, the risk of the effort derailing the economy is likely to be relatively small.

If there is genuine concern about the cyclical consequences of the deficit reduction effort, it would make more sense to spread the restraint more evenly throughout the plan period than to lengthen the period of time used to achieve balance. Both the Budget Resolution plans and the President's plan load the fiscal restraint into the first year and the last few years. Given the present uncertain state of the economy and the fact that it is already too late for easier monetary policy to do much to offset the effects of any cutback in fiscal year 1996 spending, it may be prudent to shift some of the fiscal year 1996 restraint called for in the Congressional and Presidential plans into the 1997 to 2000 period. Similarly, it would make sense to move a portion of the cuts that have been loaded into the final years of the plans into the middle years.

Even though the planned spending cutbacks may pose only a slight risk to the economy, they could impose significant hardship on those individuals who have little ability adjust when the transfer payments or services they receive from federal programs are reduced or the orders their businesses receive from the government are suddenly curtailed. Undesirable program disruptions could also result if state and local governments and non-profit entities are suddenly faced with new responsibilities that require administrative and institutional capabilities that they have not yet had an opportunity to develop. The more program changes called for by a deficit reduction plan, the more sense it makes to spread the adjustment out over a longer time period in order to facilitate a more orderly and sensible transition.

Judged on this dimension alone, the President's plan probably requires the shortest implementation period because its budget cuts and program adjustments are significantly smaller than those of the Congressional plans. The spending cuts and program adjustments called for by the House version of the Budget Resolution, in contrast, are the most far reaching. They not only eliminate a larger estimate of the deficit, but also provide for a substantial tax cut. In addition, they would place significant new responsibilities on the states because Medicaid and several welfare programs are transformed from open-ended federal matching grant programs into block grants. On this score, it would make sense to phase in the House plan over a longer period of time than the President's plan. Whether that period is seven, eight or ten years long is open to debate.

The credibility of the plan is the third factor that should be considered when deciding on the length of time over which to balance the budget. In recent years, deficit reduction delayed often has been deficit reduction avoided. When a deficit reduction plan stretches over many years, policy makers will be tempted to backload the sacrifice into the plan's final years. Claimants will always hope that circumstances will change and the retrenchment will be canceled before the day of reckoning. For this reason, a credible deficit reduction plan can not be stretched out over too long a time period.

Whether seven or ten years constitutes the boundary of a reasonable time period for a deficit reduction package is debatable. But it is worth noting that a decade is longer than a single individual can remain in the White House. Furthermore, during recent ten year periods we have seen world conditions change dramatically, the attitude of the public toward government swing 180 degrees, and the economy shift course in significant ways. All of this argues for the shorter time span.

*How Should the Budget be Balanced?*

While the major difference between the President's plan and the plan being developed as part of the Fiscal Year 1996 Budget Resolution is the amount of deficit reduction each would impose, they also differ with respect to how a balanced budget would be achieved. Because the plans reach balance in different years and because the baselines are different, any comparison of the approaches necessarily involves some distortion—some comparisons of apples with oranges.

Looking at the target year for each plan---that is, 2002 for the Congressional plans and 2005 for the President's plan---the policy-related spending cuts amount to about $302 billion in the House-passed version of the Budget Resolution, $272 billion in the Senate-passed version of the resolution, and $188 billion in the President's plan. Of the total cuts in the target year, the President's plan looks to discretionary spending and Medicare to bear relatively more of the burden than is the case with the Congressional plans (See Chart 3).

In spite of these differences, the composition of future federal program spending would not be affected in a major way if one of the approaches to balance the budget were adopted over another. For example, the three plans anticipate non-defense discretionary spending amounting to between 15.5 percent and 15.8 percent of all non-interest spending (See Chart 4). While the President's approach expects a smaller portion of program spending to be devoted to defense and more to Medicare and Medicaid than do the Congressional plans, these differences are quite modest when compared to the compositional shifts that have taken place over past five to ten year periods.

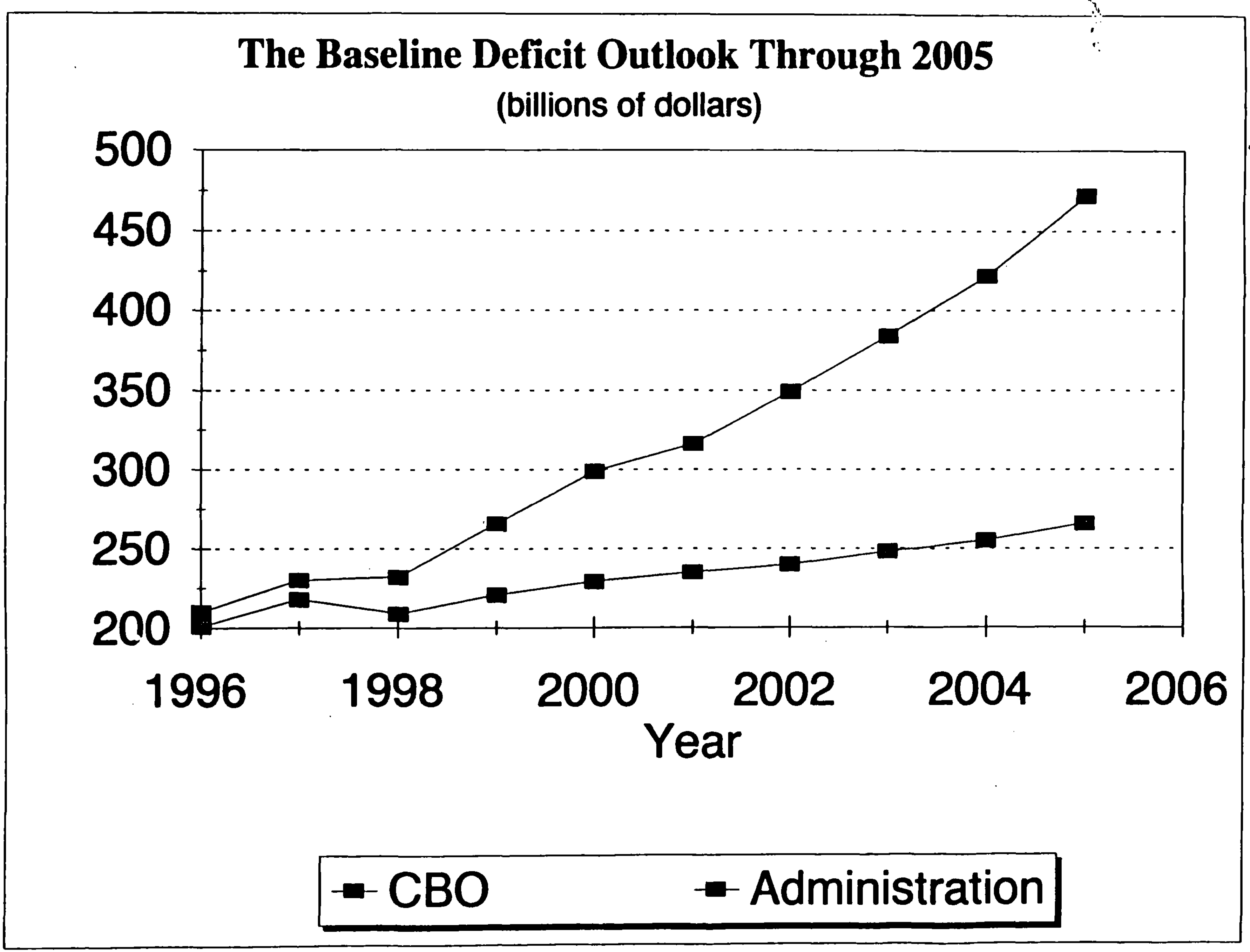
### *Conclusion*

As was the case in 1990 and 1993, policy makers have an opportunity this year to address the major problem facing the nation. This opportunity should not be sacrificed on the altar of short-run political advantage. Nor should it be squandered because the President and the Congress disagree over the size of the problem or the length of time needed to resolve it. A balanced budget may be symbolically important, but from an economic standpoint reaching a $50 billion deficit would represent a tremendous accomplishment. It is certainly better to enact measures that would cut the deficit in half over the next seven years than to come up empty handed.

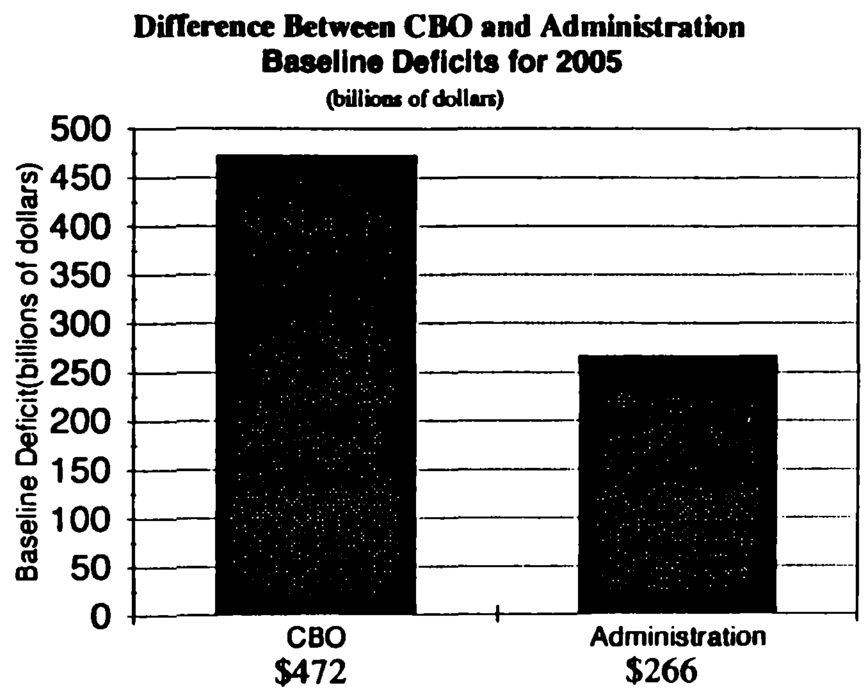
Even if the Congress approves measures that are projected, using current assumptions, to lead to a balanced budget at some future date, we all know that economic shocks, changing priorities, and unforeseen demographic and technical developments will soon render these estimates invalid. Many mid course corrections will be required. Keeping the nation on an appropriate fiscal policy path is a never-ending task.

Thank you.

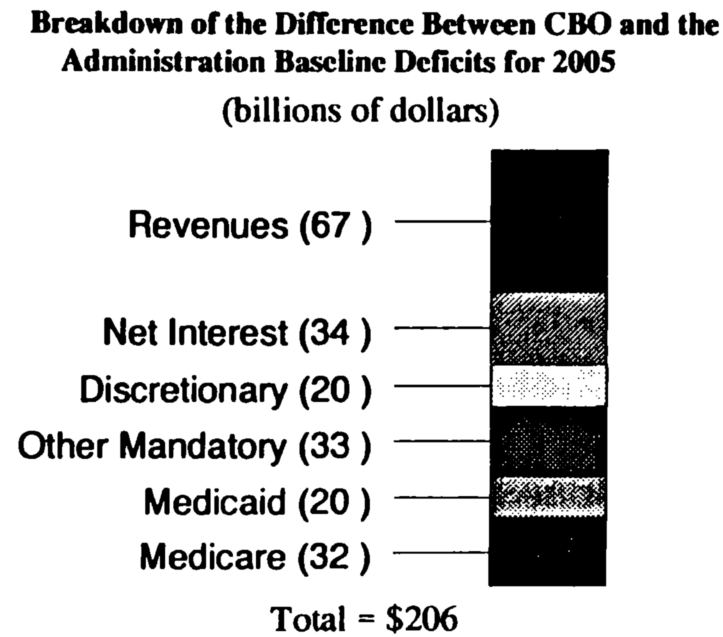
**Chart 1**


The Baseline Deficit Outlook Through 2005
(billions of dollars)
500
450
400
350
300
250
200
1996
1998
2000
2002
2004
2006
Year
CBO
Administration

## Chart 2



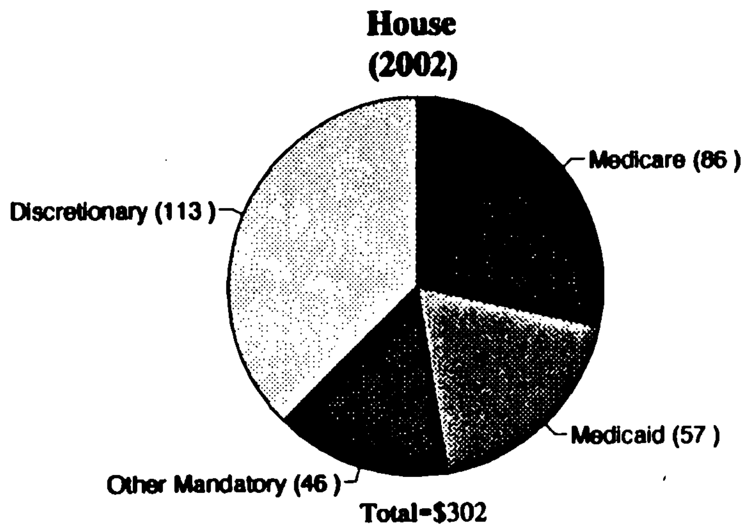
Difference Between CBO and Administration
Baseline Deficits for 2005
(billions of dollars)
Baseline Deficit(billions of dollars)
500
450
400
350
300
250
200
150
100
50
0
CBO
$472
Administration
$266

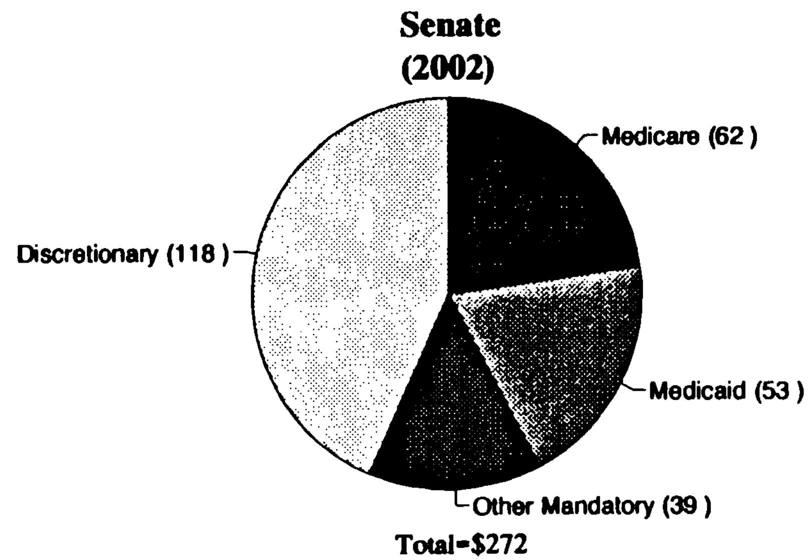



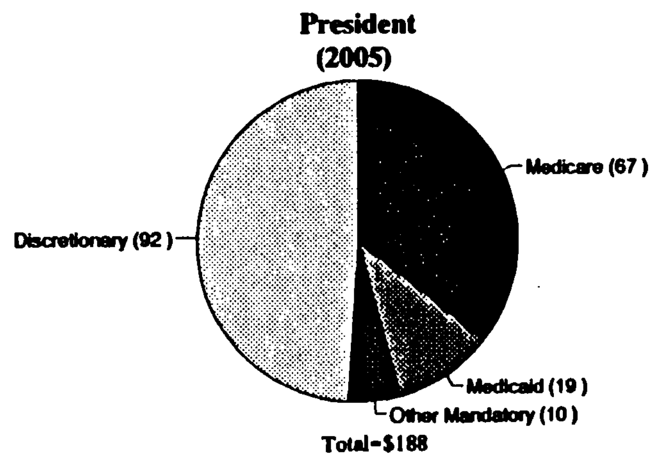
Breakdown of the Difference Between CBO and the Administration Baseline Deficits for 2005
(billions of dollars)
Revenues (67 )
Net Interest (34 )
Discretionary (20 )
Other Mandatory (33 )
Medicaid (20 )
Medicare (32 )
Total = $206

## Chart 3

### Compositon of Policy-Related Spending Cuts In Budget Balancing Plans' Target Year
(billions of dollars)



## Chart 4

**Composition of Non-Interest Outlays in Budget Balancing Plans' Target Year**