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FEDERAL BUDGET OUTLOOK

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

JANUARY 26, 1995

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THURSDAY, JANUARY 26, 1995

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice at 9:30 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Bob Packwood (chairman of the committee) presiding.

Also present: Senators Chafee, Grassley, Hatch, D'Amato, Murkowski, Nickles, Moynihan, Baucus, Pryor, Rockefeller, Conrad, Graham, and Moseley-Braun.

OPENING STATEMENT OF HON. BOB PACKWOOD, A U.S. SENATOR FROM OREGON

The CHAIRMAN. We will come to order. I want to thank Dr. Reischauer for coming this morning, and also thank him personally for all the effort he did on my behalf in analyzing the 1980 and 1981 budget picture.

All of the press and all the members will find the two letters on your desks from Dr. Reischauer to me last year, explaining what happened in 1980 and 1981.* He summarizes it a bit in his testimony, but I will say it again only to indicate that we are not in the same situation now that we were then.

Whether we were rightly or wrongly in it then is neither here nor there. We thought we were right. And at the time we all thought—CBO, OMB, most private economists—we would have someplace between a $150 and $200 billion surplus by 1985. This was in 1980 and 1981.

Most of the Reagan tax cuts were premised on reducing the surplus, and it was a static estimate. Cut the rates, cut the revenues and cut the surplus. And I think the President probably correctly feared that, if the Government had the money, we would spend it, we would not use it for deficit reduction.

So the bulk of it was designed to reduce the expected surplus. The President did have some other tax cuts that were premised on spending cuts. Then we got into a bidding war in 1981 between the President, the House, and the Senate. Everybody one-upped everybody else, and we picked the most expensive of everything we could find in the package and put it together in the 1981 bill. And the spending cuts never got adopted. So some portion of the deficit was due to the fact that we did cut taxes, and did not cut spending.

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*The letters appear in the Appendix following Dr. Reischauer's prepared statement.

But, as I recall Dr. Reischauer's testimony—I have read it—I think he estimates about 75 percent of the shortfall was economic forecast, not tax cuts.

Now the only reason I say that, I do not want to go back and revisit 1980 or 1981, or get into a argument about Laffer curves and supply-side. The cuts were not supply-side Laffer curve cuts. They were static cuts. But, at the time, we assumed $150 to $200 billion surplus.

Today we are looking at baseline deficits of $200 to $400 billion or more as far as the eye can see. And whatever we are going to do in terms of trimming spending or balancing budgets, or what not, has to be premised on the best information we can have.

Can it be wrong? Yes. We were wrong in 1980 and 1981. But to say we were wrong, and therefore pay no attention now, and go on the assumption that the projected $200 to $400 billion deficits are wrong, and they are not going to materialize, and we are really going to have balances or surpluses, I think would be irresponsible.

So, Doctor, I appreciate the extraordinary effort you and your shop had to go to in putting together those 1980–1981 figures. I know it was not easy to pull them together, but I think you will all find that the letters from him—and you have in front of you—fully explain what happened at that time. And what we were estimating at that time is not what we are estimating now.

Senator MOYNIHAN.

OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK

Senator MOYNIHAN. Yes sir. I would like to join in thanking Dr. Reischauer for this analysis, which very clearly supports an argument you have made with some vigor. And we were all here at that time, so we ought to have some memory of it.

But I want to also say, and I do not think you would disagree, that there was a component of opinion, whatever that means, in the White House and the Executive Office of the President that viewed the onset of deficits with a measure of relish, saying this would require the reduction of the size of Government.

And then, of course, that did not take place. But the formulation starved the beast. It was begged then as a strategy, as a political strategy, a legitimate strategy. But it needs to be acknowledged as one that deficits will require certain political choices that otherwise would not be made. And of course they were not made. [Laughter.]

The CHAIRMAN. Dr. Reischauer. Oh, pardon me, Senator Chafee.

OPENING STATEMENT OF HON. JOHN H. CHAFEE, A U.S. SENATOR FROM RHODE ISLAND

Senator CHAFEE. Thank you, Mr. Chairman. Just briefly, I suppose Dr. Reischauer and his group have a lot of time on their hands these days. You do not have to do a health care estimate every two weeks.

But seriously, I do want to thank you for all you did last year, to help us in the Mainstream Coalition with our estimates and, indeed, with the Republican health care task force with its estimates. You and your shop worked very hard in a very difficult area, and I know you were being approached from every direction for one more health care plan. And I want to express my appreciation for what you did, Doctor.

Dr. REISCHAUER. Thank you.

The CHAIRMAN. Senator Graham?

Senator GRAHAM. Thank you, Mr. Chairman. I have no opening statement.

I was not here during those period in the early 1980's, so I cannot comment from personal history.

Senator MOYNIHAN. You do well to disassociate your self. [Laughter.]

Senator GRAHAM. Actually I was not born until that was all over. [Laughter.]

The CHAIRMAN. Dr. Reischauer.

STATEMENT OF DR. ROBERT D. REISCHAUER, DIRECTOR OF THE CONGRESSIONAL BUDGET OFFICE

Dr. REISCHAUER. Mr. Chairman, and members of the Committee, I appreciate the opportunity to appear here this morning.

With your permission, I will submit for the record my prepared statement, and speak briefly about the three issues that are raised in the letter of invitation, namely, CBO's new economic and budget forecasts; the economic and budget situation that prevailed in the period just before the passage of the Economic Recovery Tax Act of 1981; and the challenge that is involved in balancing the budget by the year 2002, which could be required if the Constitution is amended, as many advocate.

The CHAIRMAN. I think you can actually skip quickly over 1980–1981. Unless I have misstated it, I think we will be very interested in how you suggest we balance the budget.

Dr. REISCHAUER. I am not going to give you a recommendation, so do not hold your breath. I am just going to describe the challenge.

With respect to the economy, CBO expects the strong growth that the economy experienced throughout 1994 to continue, only slightly abated, into the first half of 1995.

Because the economy is operating close to i s potential, that growth will increase inflationary pressures. And t is likely that it will also trigger additional efforts by the Federal Reserve Board to rein in the economy by higher short-term interest rates.

As a result of this monetary tightening, and the monetary tightening that has already occurred, we expect that the economy will slow down in the second half of 1995, and slow down further in 1996.

On a fourth-quarter basis, the real economic growth in 1994 was 3.7 percent. CBO expects that the economy will grow at 2.5 percent in the current year, and at about 1.9 percent in 1996

Over 3 million new jobs were created in 1994 and that led to an average unemployment rate of 6.1 percent. The unemployment rate for the current year should average around 5.5 percent, which is close to what it is now, and then it will inch up around 5.7 percent in 1996, as the economy slows.

I want to point out that both of these figures—the 5.5 and the 5.7—are below CBO's 6-percent estimate of the rate of unemployment that is compatible with nonaccelerating inflation.

While inflation has been quite subdued for the past 2 years, running about 2.8 percent, both in 1993 and 1994, CBO expects it to pick up modestly because, as I said, unemployment is below the nonaccelerating rate and because actual output is exceeding the economy's potential right now, by our judgment.

Senator MOYNIHAN. Dr. Reischauer, the Chairman very graciously said that we could interrupt if we want to emphasize a point.

Dr. REISCHAUER. Sure.

Senator MOYNIHAN. You are suggesting that a 6-percent unemployment rate is——

Dr. REISCHAUER. It is our estimate of the rate that is compatible with nonaccelerating inflation.

Senator MOYNIHAN [continuing] Now, 30 years ago the Council of Economic Advisers suggested a 4-percent rate, and that was thought high. And the Kennedy administration settled for an interim goal of 4 percent.

That is a big shift, is it not? A 50-percent higher——

Dr. REISCHAUER. Well, there has been a lot of research and a lot of controversy in the economics profession over exactly what the nonaccelerating rate is. And there are economists—Bob Eisner at Northwestern University is one example—whose estimate would be down closer to a 5 percent rate.

Senator MOYNIHAN [continuing]. But I——

Dr. REISCHAUER. Excuse me.

Senator MOYNIHAN [continuing]. Eisner would say five, which would have regarded as high 30 years ago.

Dr. REISCHAUER. High then, yes. And these are estimates that are influenced by changes in the structure of our economy and by demographic changes as well, when the labor force has——

Senator MOYNIHAN. What has——

Dr. REISCHAUER. Excuse me.

Senator MOYNIHAN [continuing]. What has changed? The stability——

Dr. REISCHAUER. For one thing, the fraction of the work force that are secondary workers, as opposed to primary workers. If all the work force consisted of males supporting families, one might get a very different answer than if all of the labor force consisted of teenagers, for example.

And so the components of the labor force—uneducated males, single parents, teenagers, wives, or their spouses in families where they are secondary workers—have fluctuated greatly.

Senator MOYNIHAN But it is now considerably higher than it was 40–50 years ago when the authors of the Employment Act of 1946 would have thought 6 percent pretty high. Would they not?

Dr. RESICHAUER. Yes. But the Employment Act was really stating a goal, what they regarded as a desirable level. At that point, I do not think there had been a great deal of research into exactly what the relationship in the United States was between inflation and unemployment rates.

Senator MOYNIHAN. Thank you.

Senator CHAFEE. Could I just ask you one quick question, Mr. Chairman?

The CHAIRMAN. Yes.

Senator CHAFEE. In other words, Dr. Reischauer is telling us that 6-percent unemployment is full employment?

Senator MOYNIHAN. Yes.

Dr. REISCHAUER. Basically, yes. It is the number that is associated with neither acceleration of inflation nor a reduction in inflation.

I would not want to suggest that it is carved in stone at 6.0. There is a margin of error, to be sure. One also has to keep in mind that if you operate the economy at, say, 5.7-percent unemployment, and 6 percent is the nonaccelerating inflation rate, you are not talking about great surges in inflation that are going to occur. You are talking about a very very modest amount of increase.

Senator CHAFEE. So if you have a situation, as we do currently in some sections of the country, I think in the Southwest, where unemployment is, say, 4.2 percent——

Dr. RESICHAUER. Yes.

Senator CHAFEE [continuing]. That means there are a lot of help wanted signs out. They are looking for people.

Dr. REISCHAUER. Somewhat more so than if you had an 8-percent rate of unemployment. Yes.

Senator CHAFEE. Thank you.

Dr. REISCHAUER. The fact that the economy is operating close to or a bit over its capacity, and that that the unemployment rate is below 6 percent, leads us to conclude that consumer prices will begin inching up. CBO expects that the consumers price index (CPI) will rise by 3.2 percent this year and 3.4 percent in 1996.

Over the course of 1994, the Federal Reserve tightened monetary policy. And the 90-day Treasury bill rate rose from 3.2 percent in the first quarter of the year to 5.2 percent in the fourth quarter. The rate on 10-year notes rose from 6.1 to 7.8 percent.

CBO expects the Fed to continue to tighten monitory policy in the first part of the year and the average interest rate on bills to be 6.2 percent for 1995. CBO expects the average rate on notes to be 7.7 percent for this full—1995—year. Rates should fall a bit in 1996 as the economy begins to slow down.

The CBO forecast implies that the Fed's efforts to restrain the economy will slow it down without causing a recession.

Other outcomes are possible. If the economy overshoots its potential by a wider margin than CBO now expects, the Fed could take more drastic actions that could presage a recession either next year or the year after.

Alternatively, the rise in interest rates that has already occurred could be enough to slow the economy down. CBO's forecast is a compromise between these scenarios. Its forecast is really quite similar to the consensus of private economists.

With respect to the budget outlook, CBO expects the deficit in the current year to fall to $176 billion, or 2.5 percent of gross domestic product (GDP). In dollar terms, that is going to be the lowest level that we have experienced since 1989. In relation to GDP, it is going to be the lowest level we have experienced since 1979.

If further policies are not adopted to reduce the deficit, the three consecutive years of declining deficits that we have enjoyed will come to an end, and the deficit will begin to rise again in 1996.

The mounting deficits will be fueled primarily by increases in Medicare and Medicaid, which are expected to grow by roughly 10 percent a year over the next 5 to 10 years.

All spending other than that for Medicare and Medicaid is projected to grow by only about half that amount, that is, around 5 percent a year. By 2005, the deficit is projected to reach $421 billion, or 3.6 percent of GDP, if one assumes that the discretionary spending that we do is adjusted for inflation after the discretionary spending caps expire in fiscal year 1998.

Turning to the second question that you asked in your letter, the budget outlook that I have just described is really very different from the one that faced the nation when the Economic Recovery Tax Act (ERTA) of 1981 was being considered. And I think your summary, Mr. Chairman, was really quite accurate.

At that time, CBO's budget reports routinely projected that a continuation of current tax and spending policies would lead to large budget surpluses. CBO also warned that these large surpluses would act as a drag on the economy, that they would slow the economy down.

These projected surpluses were primarily generated by the rapid growth of revenues that resulted from the interactions of high rates of inflation and an unindexed tax system.

In our July 1981 report, CBO projected that revenues collected under the then-current tax system would climb from about 21 percent of GDP to 24 percent of GDP by 1986, and that the 1981 deficit of $79 billion would turn into a surplus of between $148 and $209 billion by 1986.

In that same report, CBO estimated that the budget would be between balanced and showing a small deficit of roughly $50 billion in 1984, if the tax cuts and other policy changes that were called for in the May 1981 budget resolution were enacted into law.

In other words, given the information available at that time, the Congress reasonably could have concluded that significant budget surpluses loomed under current law, and that that 1981 tax cuts would leave the budget somewhere between balanced and experiencing a relatively small deficit.

As it turned out, the Federal Government ran deficits of about $200 billion a year from 1983 through 1986, primarily because the economy was far weaker than either CBO or the Administration anticipated at the time the 1981 tax bill was being considered.

The economy plunged into a recession and then recovered, and the rate of inflation dropped very sharply. By 1986, nominal GDP was about $700 billion smaller than was assumed in 1981, which caused a corresponding drop in tax revenues. Despite the plunge in inflation, interest rates remained very high.

It is reasonable then to ascribe nearly all of the underestimation of deficits during that period to errors in economic forecasts. The bottom line is that, although large deficits characterize both the current budget outlook and the actual experience of the 1982-1986 period, the budget outlook when ERTA was being debated was far different from the situation that we face today.

Now the third question, which is what would it take to balance the budget in the year 2002? This would be required if the Constitution was amended successfully. According to CBO's projections, some combination of spending cuts and tax increases totaling $322 billion in the year 2002 would be required to eliminate the deficit in that year.

There are many possible paths to reach that objective, and I presented one of those for illustrative purposes on the last page of my prepared statement. This particular path first freezes discretionary spending through the year 2002 at the dollar level of the 1998 caps for discretionary spending.

That action, together with the resulting debt service effects, would produce $89 billion of the $322 billion in saving that would be needed to balance the budget in that year. The buying power of discretionary appropriations in the year 2002 would be about 20 percent less than the buying power of current-year appropriations for discretionary programs.

This illustrative path next assumes further savings from policy changes. The pattern is similar to that of the mandatory program savings contained in the reconciliation bills of 1990 and 1993.

If these savings were achieved entirely out of entitlement and other mandatory programs, excluding Social Security, they would represent about a 20-percent reduction from current policy levels for those programs.

The CHAIRMAN. On average, for all entitlement programs.

Dr. REISCHAUER. Except Social Security.

The CHAIRMAN. Except Social Security.

Dr. REISCHAUER. And the responsibility for making many of these cuts, of course, would fall largely to this Committee.

The CHAIRMAN. And, to the extent that Medicaid and Medicare are going up 5 or 10 or 15 percent a year, a 20 percent reduction from current policy?

Dr. REISCHAUER. From current policy. This would be a reduction from that rise.

The CHAIRMAN. So if we were presuming a 15-percent increase, you would presume a 5-percent decrease?

Dr. REISCHAUER. Decrease in spending. Yes.

Looking at the 1996–2002 period, the savings in CBO's illustrative path that result directly from policy changes total more than $1 trillion. And the associated debt services saving amounts to around $175 billion.

But this picture is probably an overstatement of the severity of the policy-related cuts that would be needed to balance the budget. If the necessary policy were enacted into law soon, and the financial markets were convinced that policy makers would stay the course, CBO would expect that interest rates would fall below those that are in its forecast. This would increase the debt service saving and reduce the amount of savings that were needed from policy changes.

If interest rates were to fall by as much as one percentage point below the level assumed in the CBO forecast by the year 2000, which I think is a plausible change that could be brought about by major deficit reduction action, the amount of saving needed over the 1996–2002 period from policy changes would be almost $140 billion less than the $1,035 trillion that is laid out in that illustrative path.

Lest I sound too negative, let me remind you that there are significant long-run economic benefits from reducing the deficit. Productivity would increase, living standards would rise, we would be less dependent on foreigners for future investment funding, and our debt to GDP ratio would begin to decline.

But the road to a balanced budget would be one that we have never traveled down before. It would involve sustained fiscal restraint averaging roughly four-tenths of a percentage point of GDP a year, which would have a contractionary effect on the economy.

To some degree, this effect would be offset by lower interest rates that would result from the reduction in Federal credit demands and possible monetary easing by the Fed, and from stronger exports brought on by reduced exchange rates. Nevertheless, there could be a few bumps along this road.

Let me conclude by noting that the magnitude of the discretionary and mandatory cuts contained in the illustrative path that I described for you are large, but they are not unattainable. Their size could be reduced, of course, if tax increases were considered to be part of the equation.

If taxes are reduced, however, deeper spending cuts are going to be required. These are the issues in which this Committee will play a major role. And how the decisions are made is going to determine the shape of our future fiscal policy in this country, maybe for a long long time.

Thank you. I will stop, and answer any questions you might have.

[The prepared statement of Dr. Reischauer appears in the appendix.]

The CHAIRMAN. Dr. Reischauer, thank you.

As you are well aware, we are considering a middle-income tax cut, or a tax cut of some kind, which we are allegedly going to pay for with spending cuts, and apparently now to be wrapped into one package, if it can be done.

In your judgment, if we can find the spending cuts to equal X amount of money, is it more important to use it for a tax cut or to reduce the deficit?

Dr. REISCHAUER. It is not my role to tell you what your priorities should be.

The CHAIRMAN. Oh, I know, but from a budgeteer's standpoint?

Dr. REISCHAUER. From a budgeteer's standpoint, one is interested in strengthening the long-run prospects for the economy. We can do that by reforming our tax and spending policies without changing our overall fiscal stance. In other words, we could redesign our tax system so it encouraged saving and investment more or change our spending policies so they did less to encourage consumption. Or we can change our overall fiscal stance by reducing Government drain on capital markets.

I think my judgment would be that the long-run health of the economy would be improved most by reducing the deficit.

The CHAIRMAN. You mentioned savings and investment and consumption. Almost everyone I talk with says, well, we ought to save more and we ought to invest more.

If you want to tilt the Tax Code in that direction—I think you said away from consumption—give me some suggestions as to some of the tax policies which, in your judgment, would lead in that direction, both as to discouraging consumption and to increasing savings and investment.

Dr. RESICHAUER. Let me start by saying that many of the actions that we have taken in the past, in hopes of achieving that goal, have had very small and often negligible impacts. So I remain skeptical that large changes in tax policy will help us to attain those objectives.

Obviously, we could shift our tax system more towards a consumption tax or a value-added tax basis and away from taxing income.

We have done a study on that—on shifting $100 billion into a value-added tax, away from the current income tax—and I think that changed the national saving rate by only about one-half of a percentage point, if I remember it correctly.

The CHAIRMAN. What needs to be done then? And it is more on the personal savings side, if I lock at the figures.

Dr. REISCHAUER. Well, we have had a decline in personal saving, but also an increase in Government dissaving.

The CHAIRMAN. Dissavings. But the business savings part has not changed as much as the personal savings part. You are right about the dissavings.

But, if we wanted to increase personal savings two or 3 percent, not 0.2 percent, what policies would, in your judgment, lead to that?

Dr. REISCHAUER. I do not know of any.

If you are asking whether I think expanded IRAs could have an effect of that sort, the answer is no, I do not think so.

The CHAIRMAN. Is cultural?

Dr. REISCHAUER. Well, if it is cultural, it is world culture because personal saving rates around the world are going down. And one has to ask, why do people save? And, you know, they save for their retirement, they save for unexpected events, they save to put their children in college, they save to buy a car.

And, as our economy has evolved, many of those needs have been reduced. We have extensive subsidized State higher education systems. We have grants and loans for students to attend college. We have a spread of social insurance that helps the elderly meet their medical bills and their retirement needs. Before we had unemployment insurance in 1935, one might have wanted to save for those periods when you found yourself unemployed.

Now, if you want to buy a consumer durable, a car or something like that, you do not have to have the same kind of down payment that one used to need. Fast Freddie is willing to give it to you with no payments for the next year. So we have done a great deal to encourage consumption. We have an industry on Madison Avenue that is designed to convince us that if we do not have absolutely everything that is being offered to the American consumer in our own house, we are deficient in some respect. In our culture, we do not encourage saving.

The CHAIRMAN. And the laws are not likely to change that. I mean, Fast Freddie will still sell you the car with no payments for a year.

Dr. REISCHAUER. Yes. No matter what the tax laws may say.

The CHAIRMAN. Our order today is Senators Moynihan, Chafee, D'Amato, Graham, Hatch, Grassley and Rockefeller.

Senator Moynihan?

Senator MOYNIHAN. Mr. Chairman, I remember 30 years ago fooling around with the notion that cultural plight, that if you really consider the ethic of capitalist accumulation—we did in the nineteenth century—there comes a time when you have to reward that accumulation by consumption. And, indeed, about the time the capital system had filled up, why the advertising system came along.

Certain Marxist critique might support that, but that will not get us anywhere with the debate in the next two weeks.

Could we ask you, just your professional judgment, about amending the Constitution with regard to these flows of income and outgo. We saw how far off we were in the early part of the 1980's in making economic projections from which you derived fiscal projections. And, anticipating a great surplus, we got a great deficit.

After a long period, during which the American Government did not have much trouble with its finances, there was a slight tendency to spend more that you have got, than you took in. But the national debt in 1979 was about $900 billion, which was no great amount if you have had two centuries to accumulate it.

And then we got into this situation which is partly international. The inflation rates came out of international events, exogenous to any political decisions around here. The Arab oil shocks, two in a row, added to that.

Given the uncertainty of the best, a very advanced population, are we going to know enough to put ourselves into a 12-month agricultural cycle of a balanced budget, and make it work? Or are we going to do as the Washington Post suggests this morning, what would really be enshrined in the Constitution is minority rule?

You probably should not answer the last question. If it takes 60 votes or 41 votes——

Dr. RESICHAUER. I will leave it to the minority to talk about that.

First, let me just say that CBO's bottom line is that procedural changes cannot substitute for political will. They did not during the Gramm-Rudman era, and they did not during the earlier periods, rein in deficits through the standard budget procedure.

I think adhering to a balanced budget limitation will require more political will than many Members of Congress realize. That is because we should have as our goal not just balance but a surplus, if you want to maintain the automatic stabilizers that are still a part of our Federal system.

Our revenue system's take rises and falls with the unemployment rate. We have a spending system that provides unemployment benefits, food stamps, and various other benefit payments that fluctuate with the unemployment rate. So, if we were under a balanced budget regime, and CBO says that the economy is really at its fully capacity, you would want to be running a surplus of a couple of percentage points of GDP so that, if and when the economy fell into a recession, those automatic stabilizers could work. Then you would not be in a situation in which you said, "Oops, the economy is beginning to slow down and go into the tank, unemployment insurance spending is going up, and cash revenues are growing slower than we thought. Therefore, we have to cut back Medicare, Social Security benefits, or whatever." That would have a contractionary effect on the economy and make the recession worse than it otherwise would be.

Senator MOYNIHAN. That is an older neo-Keynesian model which we have shown ourselves capable of producing deficit as a stimulus. But producing surpluses as a suppressant we have not been very good at.

But could I just make a point of thanking you for what you have said.

I would like to say to the Chairman, who I do not think will be much impressed, but about 30 years ago, or 35, Guthrie Burkhead, who was then dean of the Maxwell School in Syracuse, observed that Americans are gadget-minded about Government. And it is a thought worth entertaining. This is the gadget of all gadgets, but I do not know that it will produce the automatic outcome.

Thank you, Mr. Chairman. Thank you, Dr. Reischauer.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

Doctor, I am very interested in what you said on page 18 of your testimony, where we get a bonus if we are headed toward a balanced budget seriously, and the markets and the people believe that we are going to stick to it.

Now, that is a winner, that is a two-fer, is it not? If we are going to get there, that is good, but then we get a bonus, we get a reward of what you estimate some one percent on interest.

Dr. REISCHAUER. This is just a reflection of the truth that major policy changes do affect the economy.

Senator CHAFEE. And, undoubtedly, it is vice versa. If it appears that we are headed for unbalanced budgets, then the interest rates on our debt increase, presumably. Right?

Dr. REISCHAUER. Yes. But I think the interest rates that CBO has built into its forecast are consistent with the slow rise in the deficit that we have projected over the next 10 years if you take no further steps to reduce the deficit.

Senator CHAFEE. All right. But, if you reverse course——

Dr. REISCHAUER. Right.

Senator CHAFEE [continuing]. And head downward, we get this reward, which you say is over the 5-year period. Well, I guess it is the 7-year period?

Dr. REISCHAUER. Yes.

Senator CHAFEE. Seven-year period, 6-year period of, you say, about $140 billion.

Dr. REISCHAUER. Right.

Senator CHAFEE. Going back to how we would have to do this, see if I understand.

In your prepared statement you mention discretionary spending. And you say that it would have to decrease by 20 percent.

Dr. REISCHAUER. There are many ways to attain balance in the year 2002. We have just created one illustrative way. Since there is a lot of talk about extending the caps on discretionary spending, we thought that it was reasonable to use a policy in our illustration the effects of which the Congress would be interested in observing.

Senator CHAFEE. Let me see if I understand.

Dr. REISCHAUER. That would mean that the spending on discretionary programs in the year 2002 would, in nominal terms, be roughly what it is today. Of course, inflation is chugging along at roughly 3 percent and that is eroding the value of a dollar. By the year 2002, the value of the dollar spent in the discretionary area would be about 20 percent less.

Senator CHAFEE. So, in effect, the discretionary items—the State Department, FBI, all the rest of that——

Dr. REISCHAUER. Defense.

Senator CHAFEE. Defense? Yes. Right.

Dr. REISCHAUER. Defense constitutes more than half of discretionary spending.

Senator CHAFEE [continuing]. Would be operating at, in effect, 20 percent less than they are operating at today?

Dr. REISCHAUER. Yes. In the aggregate.

Senator CHAFEE. What do you mean, in the aggregate?

The CHAIRMAN. You would not get to cut each of them 20 percent, in terms of real dollars.

Dr. REISCHAUER. No. You could wipe some of them out completely and give raises to others.

Senator CHAFEE. I appreciate that.

The way you portray this, and that is a pretty dramatic point right there—I know this is just illustrative of how to get there—but the rest of what you said, it does not seem that dramatic to me. You exclude Social Security in your illustration. And what have you done on the other entitlements?

Dr. REISCHAUER. In this illustrative path, what you have to do is——

Senator CHAFEE. Let us call it the Reischauer Plan.

Dr. REISCHAUER. The Reischauer Plan. I am leaving anyway. I do not want to be driven out. [Laughter.]

It turns out that the cuts required in mandatory programs are of a similar order of magnitude. These, of course, are programs that are rising largely because of cost-of-living increases, increased medical expenditures, more people on AFDC or food stamps, whatever.

We are saying that you would have to take our judgment of where those programs will be in 2002, and reduce it by 20 percent.

That could be done by lowering benefit levels or by restricting eligibility.

But you are talking about farm price supports, veterans' programs, the student loan programs, the means-tested benefit programs, civil service and military retirement. There are a lot of tough nuts in this package.

Senator CHAFEE. I think we are aware of those.

Would you get a reduction in interest on the debt if you were headed downward on a very steady path but, let us say, not headed toward a balanced budget?

Dr. REISCHAUER. Yes. I would expect that any substantial multiyear package would get you an interest rate bonus.

Senator MOYNIHAN. We did something like this in the last 3 years, have we not?

Dr. REISCHAUER. Yes. We have.

Senator CHAFEE. So, obviously, you might not get probably as much as if you were heading toward a balance budget, but you would get a reward of some type?

Dr. REISCHAUER. Yes.

Senator CHAFEE. Thank you.

Dr. REISCHAUER. That is right. And let me just factor in for you that additional interest rate saving. We said that it is about a 20-percent cut in discretionary spending, and a 20-percent cut in mandatory spending. In that illustrative path, if you said we are going to do it, and we are going to get this interest rate bonus, as the Chairman suggested, of the order of magnitude that I suggested, the 20 percent would come down to about 17 percent.

Senator CHAFEE. Oh, because——

Dr. REISCHAUER. You would need less in the way of policy adjustments, because you would have more debt service savings.

Senator CHAFEE. And the bigger the debt, the bigger the savings.

Dr. REISCHAUER. That is the silver lining in an otherwise very dark cloud.

The CHAIRMAN. Senator D'Amato. And then Senator Graham.

Senator CHAFEE. Thank you, Mr. Chairman.

Senator D'AMATO. Thank you, Mr. Chairman.

Mr. Reischauer, Senator Murkowski points out to me that, on page 11 of the "Economic and Budget Outlook" which accompanies your testimony, you conclude by saying, "Although the currency crisis in Mexico has had a large impact on individual investors and corporations and will probably depress the growth of the Mexican economy next year, its overall impact for the United States appears to be small."

Is that your feeling?

Dr. REISCHAUER. Yes. The fact is that the Mexican economy is small compared with our economy. Our exports to Mexico amount to roughly 1 percent of our GDP. A slowdown in the Mexican economy, even a modest recession, is obviously not going to eliminate our exports to them. It is going to dampen them somewhat.

Then there is another impact that has to do with immigration, and what happens there.

Senator D'AMATO. Well, that ~~seems~~ to be rather overblown. I even read today that some experts estimate that, instead of a projection of an additional half-million a year, it might be maybe 40 thousand more. I say that because, again, we were presented with a picture that the consequences would be almost catastrophic, as it relates to our economy.

Then, when I see this, and again you open it up by saying, "Although the crisis is likely to have significant effects on the Mexican economy, the overall effect on the U.S. will be small.", I have a very real question as to what will the impact be if we put up $40 billion, and we find that we have a government that is incapable of making the structural changes that everyone feels they have to make? How would we, as big brother, come in and impose these conditions? You know, is it practical?

Is this a campaign of fear when we say that the borders are going to be invaded, and that we are going to have tens and tens of thousands more people moving across the borders?

That is why I found your conclusion to be at variance with what has been suggested to date by the Administration in its official position.

I will not go any further, but I certainly will bring this up to the administration.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman.

I am looking at table 5, which accompanies your statement. And you start with a list of deficits with discretionary inflation after 1998.

How is the surplus from various trust funds, particularly Social Security, incorporated in arriving at those numbers?

Dr. REISCHAUER. It is included in those numbers. The surplus from the Social Security trust fund, as well as the growing deficits in the hospital insurance, Medicare Part A trust funds, the surpluses in the civil service and military retirement trust funds. Those are all part of that number.

The CHAIRMAN. It is a consolidated deficit.

Dr. REISCHAUER. It is a consolidated deficit. Correct.

Senator GRAHAM. Could you tell me what is the Social Security surplus that is incorporated in each of those numbers, beginning with 1995?

Dr. REISCHAUER. Yes.

Are you ready?

Senator GRAHAM. Yes.

Dr. REISCHAUER. All right. Sixty-nine billion dollars in 1995, $73 billion in 1996, $78 billion in 1997, $84 billion in 1998, $90 billion in 1999, $96 billion in the year 2000, $104 billion in 2001, and $111 billion in 2002.

Senator GRAHAM. Am I correct that, if Social Security were excluded from the calculation——

Dr. REISCHAUER. The deficit would be that much higher.

Senator GRAHAM [continuing]. So, in the year 2002, as an example, instead of being $322 billion, it would be $433 billion?

Dr. REISCHAUER. $433 billion. Correct.

The CHAIRMAN. Bob, let me interrupt just a moment.

We have two votes, and I think they are back to back. So I want to know if we can go on for another 5 minutes. And then we have to stop for about half an hour, because that first vote will be 20 or 25 minutes by the time we finish it.

I want to know if the Committee wants to come back and quiz Dr. Reischauer further.

Senator ROCKEFELLER. I do.

Senator GRAHAM. Yes.

The CHAIRMAN. All right. Then we will go about another 5 minutes now, then break. And those who want to come back will.

Senator GRAHAM. I would like to, with that background, ask some questions about the composition of the Constitutional amendment to balance the budget.

What is your thought as to whether Social Security and other trust funds should or should not be on budget, that is, calculated in arriving at what is the stated annual deficit, as you have done, or whether they should be excluded?

Dr. REISCHAUER. From an economic perspective—and this is not speaking to politics or to other concerns—economists are interested in the total amount by which Federal activity puts a demand on private credit markets. And that is all activity. It does not matter whether we put a label of Social Security on it, or defense, or highway trust fund. It is the whole package that matters.

By running surpluses in the Social Security trust fund right now, we are reducing the amount by which the Federal Government has to go and borrow from private credit markets.

If one segregated the Social Security trust funds somehow, and put them aside—and there have even been proposals that they be invested in securities other than Treasury securities—the Federal Government would have to go out and borrow that much more from the private sector. But there would be those who are now investing in bonds, corporate bonds, stocks, whatever, who would be displaced by the Social Security purchases, and would move into the Government market.

So, my answer is, I think, that the more comprehensive the better, from an economic perspective.

Senator GRAHAM. Mr. Chairman, I would say that I am intrigued with what Mr. Reischauer just said. And I am tempted to want to pursue that line. But I would hope that, at some future hearing, we might be able to pursue that particular question of the investment policy of Social Security and the impact of those policies on the total capital markets in more depth.

The CHAIRMAN. There was a serious discussion in 1979, 1980 and 1981—again, you were not here—as to whether we should open up and let Social Security invest beyond Government bonds, to which somebody said yes—Texas real estate.

I hate to think what the bailout might have been for the Social Security fund had they invested not unlike the S&L's.

Senator GRAHAM. The second question about the structure of the Constitutional amendment, it uses the year 2002 as the target date for reaching the goal of a balanced Federal budget.

As an economist, do you have any recommendations of how we should go about thinking, assuming that we are going to do this, what is the appropriate target date of for the attainment of the goal?

Dr. REISCHAUER. I think a 7-year period is a sufficient period of time in which to bring down the deficit to balance without disrupting the economy unduly.

But there are always bumps along the road, as I said. There are things that we cannot predict right now. Of course, that makes one a little reluctant to lock in place any particular year as a drop-dead year.

The Constitutional amendment, as it is now framed, says 2002 or 2 years after ratification. If you were to do nothing between now and the year 2000, and then went on a forced march for 2 years to balance the budget, it would be highly disruptive, not just on the economy, but on the programmatic structure and political civility in this Nation.

So I think it really is incumbent on you that if you do send a Constitutional amendment to the States for ratification, you immediately get down to the task of achieving a balanced budget in credible ways.

Senator GRAHAM. Which would, for instance, indicate that in fiscal year 1996, we should be looking at additional deficit reductions beyond that achieved through a freeze of approximately $33 billion.

Dr. REISCHAUER. That is what we have done in this illustrative path. The general pattern of deficit reduction measures that you approved in 1990 and 1993 is one in which you take a modest sized bite in the first year and then a larger bite in the next year. You phase in the cuts. I think that is an appropriate way to go.

Senator GRAHAM. Can I ask one last question in my remaining time?

The CHAIRMAN. Sure.

Senator GRAHAM. Have you done an analysis of your proposed method of reaching a balanced budget by the year 2002 on various income groups of Americans? What would this do in terms of——

Dr. REISCHAUER. There is really no way to do that because, not only are there many other paths, but within this particular path, there are an infinite number of ways these cuts could be meted out. You could eliminate the means-tested programs to achieve the mandatory savings. Then the conclusion would be that you have hurt low-income people.

Or you could cut benefits for upper-income Social Security recipients or military and civilian retirees, in which case you would get the opposite result.

Senator GRAHAM. If you were to take a further assumption, and that was a qualitarian approach that you cut evenly across the board in these program areas, could you calculate what the effect of that would be by income classes in America?

Dr. REISCHAUER. We would need a lot of specificity about exactly what the programmatic changes would be.

You know, it is not impossible to design a set of policy changes that would have roughly similar percentage impacts on each income quintile.

The CHAIRMAN. We have about six minutes left on the vote.

We will be back as soon as we can.

[The Committee recessed at 10:28 a.m., to reconvene at 10:48 a.m.]

The CHAIRMAN. I am prepared to ask Dr. Reischauer a question until somebody else gets here, and it is their turn.

Flesh out a bit your comments that I read in the paper yesterday about the CPI, and your statement of kind of a mean at .5. And you thought it was overstated, maybe.

Dr. REISCHAUER. We issued a paper at the end of last year on this issue. in which we examined——

The CHAIRMAN. I heard you asking about the CPI, and is it overstated?

Dr. REISCHAUER [continuing]. The consumer price index. We examined the possible sources of misestimation and came to the conclusion that, given the available evidence that the CPI does overstate the cost of living. Much of the evidence has been provided by analyses of the Bureau of Labor Statistics. This is an issue that the BLS is concerned about, has been working hard on, and has a lot of expertise in.

My judgment was that the current CPI estimates probably overstate the cost-of-living increases somewhere between two-tenths and eight-tenths of a percentage point a year.

Taking half a percentage point as a midpoint, CBO calculated that if you reduced the COLAs for all indexed programs by CPI minus half a percentage point and used that reduced inflation measure to adjust elements of the income tax, it would save something on the order of about $65 billion over the next 5-year period.

The CHAIRMAN. In the aggregate? Total?

Dr. REISCHAUER. In the aggregate. Total.

So if it grows slowly, it is roughly $25 billion in the——

The CHAIRMAN. FIFTH YEAR?

Dr. REISCHAUER [continuing]. Fifth year, in the year 2000.

That includes, I believe, debt service. I mean it is an assumption that the deficit would be that much lower if we did it.

The CHAIRMAN. Senator Rockefeller.

Senator ROCKEFELLER. Thank you, Mr. Chairman.

And I am very grateful to you for allowing this hearing to continue. I think I am the only one who said I wanted to continue!

The CHAIRMAN. I have a hunch a couple more are coming back.

Senator ROCKEFELLER. Are they? Good. All right. Dr. Reischauer, let me just say that every time I look at you, I think of your father. And not only do you look like him somewhat, but he was the greatest expert on Japan this country ever had, and he had a profound influence on my life. And I just wanted to say that to you, as I have before.

In the Bureau of National Affairs, there is an item which says that Speaker Gingrich said, "By definition, every citizen who decides to take a Medicare HMO in that State is saving the taxpayer 5 percent of the average cost of Medicare."

The CHAIRMAN. Who said this, Jay?

Senator ROCKEFELLER. Newt Gingrich. And then, not in quotes, this article reports a number of Republican Members and aides who say that they hope to reduce the growth in Medicare costs by increasing beneficiary participation in managed care organizations.

So, drawing on those two comments, I want to ask this. You said that in order to balance the budget, you have to have cut entitlement by approximately 20 percent, including Medicare, by the year 2002. I think CBO correctly—because this is what I have always felt—has credited HMO's and managed care in general for reducing costs, by about 10 percent, but only for the first year. Then, after that, the savings rapidly disappear, virtually entirely.

So, if all seniors were required by law to receive their care from an HMO, would CBO—do not answer quite yet—would CBO only assume the one-time savings cost of 10–20 percent in Medicare that you traditionally have used? That is my question.

Now this is obviously theoretical. I think it is not politically in the cards that we are going to tell 85-year-olds that they have to join an HMO. That is another judgment entirely. But I think it is very important to know, even if it is theoretical, if all seniors were enrolled in HMO's, if CBO does what they have done in the past, will you still say we must make a 20-percent reduction in Medicare to balance the budget by 2002.

I would like your response to that.

Dr. REISCHAUER. The distinction you make is a very important one. And that is between the level of spending and the rate of growth of spending.

CBO's judgment has been that effective group and staff model health maintenance organizations can reduce the level of spending by around 10 or 12 percent. But in the current environment, this would have very little impact on the rate of growth. But that does imply that 5 years from now, spending would be 10 percent or so lower.

I should add that we are now evaluating the latest health interview survey—the 1993 survey—that has some new data that has not been available before and some new questions about it. In a month or so, we will be releasing a new study on the effectiveness of managed care that might modify somewhat the assumptions we have had before.

I would like to go back—because I think this is a very important issue—to the statement of the Speaker because I think it reflects a misunderstanding of the way the current Medicare HMO option is structured.

Right now——

Senator ROCKEFELLER. Mr. Chairman, he is going to give an extra point, which I welcome. But I want to ask one more tiny question.

The CHAIRMAN. That is fine. We are in pretty good shape on time here.

Senator ROCKEFELLER. Please. This is out of my time here. [Laughter.]

Dr. REISCHAUER. The current Medicare HMO option allows participants in the Medicare program to join certain HMOs. Those HMOs are reimbursed at about 95 percent of the average spending in that particular geographic area for Medicare individuals.

There have been some studies of this, and the studies suggest that the 95 percent is an overpayment because the types of individuals are attracted to this option are both healthier and not high utilization folks. And, in fact, if they were in the standard Medicare program, we would be paying less than 95 percent of the average in that area.

If we just continue the existing system or calculations and reimbursements, it would not lead to any saving. Moreover, it is very important to remember that, as opposed to most health care systems where you have an open enrollment period, maybe for a month each year, Medicare participants who enter an HMO can change their decision each month. They could be in an HMO as long as things were going well, and then when they got sick, decide to go back into the existing, standard system.

You would have to change the structure of the current option to achieve any kind of savings. So you would not only have to move many people in, but also say that they cannot move back, except maybe once a year, or something like that.

Senator ROCKEFELLER. So you are talking about a very different kind of system——

Dr. REISCHAUER. A very different kind of system than the HMO option we now provide to Medicare beneficiaries.

Senator ROCKEFELLER [continuing]. Which only about 6 percent——

Dr. REISCHAUER. A very small percentage. Yes.

Senator ROCKEFELLER [continuing]. Are availing themselves of, in any event. I am very glad you made that point.

My second one is very very short, and that is on Medicaid. It is expected, and you have projected, that it is going to grow by about 10 percent into the next century. People are talking about capping entitlements. And that is fine. But people have to understand consequences when they are talking about that.

You said Medicaid spending is going to go up 10 percent for the foreseeable future. If it were capped—and people are talking about capping Medicaid at let us say the 7 or 8 percent level—who would end up absorbing the health costs that the Federal Government would no longer therefore have to pay?

Dr. REISCHAUER. That is a question that is impossible to answer. There are a number of possibilities.

First, States might have to pick up the bill if they wanted to keep the benefits and the provider reimbursements the same.

Senator ROCKEFELLER. So they could just decide to cut the benefits, or not pay?

Dr. REISCHAUER. If they decided not to, States would have to pony up more money. Alternatively, provider reimbursements could be cut back. They are already fairly low in the Medicaid program, as you know, well below those for the Medicare program or for private insurance.

And, if providers decided to continue to offer services to Medicaid recipients, it would come out of the hide of the providers, the hospitals, the doctors, the laboratories.

There is a third possibility: that access would be restricted. It would be harder for low-income people to find providers that would service them. They would, therefore, receive less in the way of health care.

Another alternative would be that the States decide to reduce the benefits that they are offering.

Senator ROCKEFELLER. The standard for which people qualify for those benefits, the percentage of poverty. Dr. Reischauer. Well, we would have to change the law on some of that. Because there are requirements now that children and pregnant women, up to a certain percentage of the poverty——

Dr. REISCHAUER. That is correct.

Senator ROCKEFELLER [continuing]. But in Alabama, I think—and I apologize to the Chairman—but I think it is still true in Alabama that you do not qualify for AFDC unless you are at 17 percent of poverty.

Dr. REISCHAUER. Yes. That is true.

Senator ROCKEFELLER. And they can control that. Again, I apologize.

Dr. REISCHAUER. But there are many provisions that also require States to offer Medicaid coverage to pregnant women and children, irrespective of whether or not they are on Aid to Families with Dependent Children (AFDC). Many States offer benefits to people at much higher fractions of the poverty level than is required by law.

So benefits could be cut back for the existing population, or the size of the existing population could be cut back. In either case, low-income individuals would receive less in the way of health services than they receive now.

Senator ROCKEFELLER. I thank you, sir. And I thank the Chairman. More people would be moving to New York.

The CHAIRMAN. I might add just a figure on Oregon. Oregon has—the Portland metropolitan area has—the highest percentage of HMO enrollment in the nation. And we have 40 percent Medicare HMO enrollment. And it is growing rapidly. Of course, that is on a voluntary basis; people sign up.

We have a number of HMO's that write Medicare. It is either three or five of them have not increased their premiums in 5 years. They are doing quite well. And they provide more benefits.

Dr. REISCHAUER. I think there is an interesting relationship between the type of health insurance that the average working American in a particular area has, and the fraction of Medicare recipients in that area who will choose this option. If you spent the last 20 years of your working life in an HMO, and are comfortable with it, it is a tremendous opportunity for you, when you turn 65 and retire, to be able to maintain that same relationship.

I think it is a different world in Oregon. And it might be a world that is slowly spreading to the rest of the country.

Senator MOYNIHAN. Well, Rochester is 63 percent.

The CHAIRMAN. Part of it is history. We had the Kaiser health plan during World War II, when Kaiser built big shipyards and, at one stage, employed 30 percent of the entire adult labor force in World War II.

After the war, Kaiser continued on, even though the shipyards closed. So, you are right. You have a lot of people who have been in the Kaiser plan all of their lives. So, when they become 65, it is nothing unique to them to continue right on in a HMO.

Senator Grassley?

Senator GRASSLEY. Dr. Reischauer, before I ask a question, I want to say to my colleagues that I ask a question of Dr. Reischauer now about defense. It may seem odd, but it is related to the work of this Committee because, if we are going to consider tax cuts—the extent to which we spend more on defense, there is less for tax cuts—or if we have got to cut other programs to provide more for defense, a big piece it is going to come out of is entitlements, which is under the jurisdiction of this Committee.

Many Members of Congress, Dr. Reischauer, are advocating a nominal freeze, or even an increase in defense expenditures. Even when we use the term "freeze" on the Hill, you usually think, well, no more impact. These Members, I think, view the election as a mandate for more money for defense. And I think I ought to make very clear, even though they talk about more money for defense, the House's Contract for America makes no mention of increasing defense spending above what the administration has proposed.

And I believe that the November 8th election stated that the voters want smaller debt limit, and for Congress to get rid of pork. They do not want Congress to move the pork over to the Pentagon. They want lower levels of spending.

So, Dr. Reischauer, can you please tell me what the cost over a 5-year period would be of freezing the fixed budget authority at the 1995 level, as modified recently by the administration? And what impact do you see a freeze in defense would have on efforts to reduce the deficit?

Dr. REISCHAUER. You are asking what if we nominally froze——

Senator GRASSLEY. Defense budget authority, nominal terms, but with the recommendations of the administration for an increase of, I think, $25 billion.

Let me repeat the question. Let me read the question again. I would like to have you tell us what the cost over a 5-year period would be of freezing the defense budget authority at the 1995 levels, as modified recently by the administration. And what impact do you see a freeze in defense would have on efforts to reduce the deficit? In other words, that is one question.

Dr. REISCHAUER. Yes. As you know, we have discretionary spending caps through 1998, that say, in the aggregate, you are not allowed to provide more budget authority than these caps have specified.

Those caps are roughly a nominal freeze. Within the discretionary menu, you can allocate resources any way you want. You can freeze defense spending or raise defense spending. It would cause you to cut something else. In and of itself, that does nothing to change the deficit numbers.

All right. Now, suppose we go then to a number that I do have. Say you wanted to keep defense spending at the 1995 level, adjusted for inflation. And there is talk that there are not sufficient resources to maintain the defense posture we want to maintain. In the period between now and the year 2002, the balanced budget year, that would cost—or absorb—$55 billion.

The CHAIRMAN. So if we cut $55 billion, we would save $55 billion?

Dr. REISCHAUER. No. You would absorb it. Of the amount you are going to spend on discretionary spending, $55 billion would be absorbed. So you would have to take the $55 billion out of other discretionary spending.

The CHAIRMAN. Oh. I see.

Dr. REISCHAUER. So, in nominal terms, if you were counting on a freeze through 2002, total domestic and international discretionary spending would have to fall at nominal terms.

The CHAIRMAN. But, I missed your point. That is just presumption. That assumes that you increased defense by CPI.

Dr. REISCHAUER. Basically, yes.

Senator MOYNIHAN. So you do not cut defense?

The CHAIRMAN. Rather than freezing it at a fixed level, you would have the discretionary accounts?

Dr. REISCHAUER. In the aggregate, yes.

The CHAIRMAN. Yes. And your freeze is a real freeze, not an inflation-adjusted freeze.

Dr. REISCHAUER. No. It is not.

The CHAIRMAN. All right.

Dr. REISCHAUER. In the illustrative example I gave you. But you are constrained to a freeze by the cap through 1998 anyway. That is the law of the land.

The CHAIRMAN. I just wanted to make sure, when you were answering Senator Grassley's question, your presumption on defense is that it would not be frozen. It would at least increase inflation. And, therefore, you would have to reduce the others by that amount.

Dr. REISCHAUER. Yes.

The CHAIRMAN. All right.

Senator GRASSLEY. So I think that $55 billion figure is close to what I was anticipating he might give us. I had a little higher figure, but I will go by your $55 billion.

Dr. RESICHAUER. I can provide for the record an exact analysis of the sort you want.

Senator GRASSLEY. All right.

Well, then I guess I would like to have you do that. Because not only do we need to have a firm figure, because it impacts what we do on entitlements. It is going to impact what we do on tax cuts. There are going to be less tax cuts. Or we are going to cut entitlements more, and spend it over in the Pentagon, as I see it.

[The following information was subsequently received for the record:]

The following table compares CBO's estimates of three alternative paths of defense spending in 1996 through 2000: one with funding provided at the level of 1995 appropriations in 1996 through 2000; a second with funding at the 1995 level adjusted for inflation in each year; and a third with funding for those years at the level assumed by the Administration in the fiscal year 1995 budget adjusted for actual 1995 appropriations and the Administration's December 1 proposed increases for readiness.

COMPARISON OF ALTERNATIVE DISCRETIONARY TOTALS FOR NATIONAL DEFENSE

(by fiscal year, in billions of dollars)

Funding Levels	1996	1997	1998	1999	2000	1996–2000
1995 appropriated level of budget authority:						
Budget Authority	263.0	263.0	263.0	263.0	263.0	na
Outlays	263.8	264.0	262.2	261.9	261.1	na
1995 appropriated level of budget authority adjusted for inflation:						
Budget Authority	272.4	281.9	291.4	301.8	312.8	na
Outlays	270.0	278.3	285.1	294.6	304.3	na
Administration's fiscal year 1995 adjusted budget plan: [1]						
Budget Authority	257.7	254.4	262.0	268.5	278.2	na
Outlays	260.1	259.5	259.8	261.6	267.8	na
1995 level minus Administration's adjusted budget plan:						
Budget Authority	5.3	8.7	1.0	−5.5	−15.2	−5.8
Outlays	3.7	4.5	2.4	0.3	−6.8	4.2
1995 level adjusted for inflation minus 1995 level:						
Budget Authority	9.4	18.9	28.4	38.8	49.7	145.1
Outlays	6.2	14.3	22.9	32.7	43.2	119.3

SOURCE: Congressional Budget Office.

na = Not applicable.

[1] The Administration's fiscal year 1995 budget plan has been adjusted for actual 1995 appropriations and for the Administration's December 1994 proposed readiness add-ons.

Senator GRASSLEY. I want to follow up on a defense question to say that many Members are justifying the need for more money because of concerns about readiness, and concerns about training. But also because of the funding gap between the Pentagon plans and the administration's budget that was highlighted in a General Accounting Office report that they did at the request of Senator Roth and myself, and a similar report that was recently done by your agency.

GAO has made it absolutely clear that there is no need for increased funding to address the overprogramming at the Department of Defense.

And I want to quote from GAO, as reported in a magazine called Defense Week. "Our report does not conclude that DOD's 5-year plan is underfunded. And, in fact, the term 'underfunded' never appears in the report."

So, two questions. First—and I will ask these together—does CBO agree with GAO that it is not necessary to increase defense spending to address the issue of overprogramming? And, second, if readiness and training are at the top of the concerns at Defense, do you think there are sufficient funds within the administration's overall defense budget to address this matter if we reallocated our spending priorities within the Defense Department, within the Pentagon? In essence, that we do not need more money to provide for readiness and training, and still meet those needs.

Dr. REISCHAUER. Let me answer the second part of that question first. My answer would be that it certainly is possible. The amount that would have to be added to bring us up to the readiness many people think is desirable is not a great deal of money and it could be shifted. But it could be shifted from other accounts, such as procurement or R&DT&E.

And you would be giving something up. I mean you would be giving the procurement of hardware. You would be giving up research, development, and experimentation. You might be giving up some other important aspect of the budget.

Senator GRASSLEY. But, as a fact, can you not really be more definitive if you connect what you just said—and I agree with what you said—with the fact that, in my first question, the report says there is not an underfunding problem. So are you really taking something away? There is a suppose that they need more money for underfunding, but GAO says it is not there.

Dr. REISCHAUER. I do not want to speak for the GAO report.

Senator GRASSLEY. Well, use your own study.

Dr. REISCHAUER. We have done our own study.

Senator GRASSLEY. Yes.

Dr. REISCHAUER. And our own study came up with an estimate that, to fulfill the objectives of the President's plan, the Defense Department needed something on the order of $65 billion more over the next 5 years.

Subsequent to that analysis, the President has suggested that he is going to provide or request more money for the Defense Department. And our number falls to $47 billion.

But this still is a shortfall. It is our estimate that, if we want to obtain the force structure, the readiness, and the other dimensions the Defense Department laid out in the plan of the administration, roughly $47 billion more than the President has already committed himself to will have to be appropriated over the next five years.

Of course, if the Congress requires the Defense Department to provide pay increases over and above those assumed in the President's budget, these numbers will go up.

If the environmental cleanup costs of some of the bases that are being closed are above our expectations, these numbers will go up. There is a lot of uncertainty here. And most of the uncertainty is on the up side.

Senator GRASSLEY. Thank you.

The CHAIRMAN. Senator Moseley-Braun?

Senator MOSELEY-BRAUN. Thank you, Mr. Chairman.

Dr. Reischauer, I would like to ask you about health care, particularly as it pertains to the elderly. It has been asserted that health care may be one of the biggest reasons that the CPI might overstate actual inflation.

However, the spending patterns of our Nation's elderly, particularly on health care, is very different than the spending of the population as a whole.

And so, if the CPI index, as currently constructed, overstates inflation in a macroeconomic sense, does it in fact overstate it for the elderly. And is that something we should talk about as we talk about this issue?

Dr. Reischauer. It certainly is a relevant issue. But we have to remember that the CPI is used to index programs other than programs for the elderly, such as the tax system.

From time to time, economists have looked at the question of whether the cost of living is increasing at a different rate for subgroups of the population—the low-income population, the middle income, the elderly. Most of the attention has focused on the elderly.

The last look at this question suggested that the CPI for the elderly was increasing a little faster than the CPI for the general population. But the authors of that study explicitly noted that they could not take account of some factors that might work to bring that elderly cost index down towards the CPIU.

One factor, is that the elderly might shop at very different stores from the average person. And they have more time. They are more likely to do comparison shopping, use coupons, and take advantage of senior citizen discounts, which are rampant in this country.

I am not saying that in a pejorative sense. I am looking forward to the time I can take advantage of these things. But, you know, the fact of the matter is that there are many stores, outlets, and services that do provide discounts to the elderly. And these discounts very often have nothing to do with the ability of the elderly to pay.

I will give you a simple example: the town my parents lived in was an upper-middle-class suburb of Boston. All the drug stores had special prices for prescription drugs for the elderly. And this was not a deprived set of people. These stores realized that because the elderly had time, they could comparison-shop, and their price elasticity of demand was much greater than it was for the rest of the population. The stores were competing for the business of those individuals.

So I think you would want to take all of those factors into account before you jumped to a conclusion. I think, at this point, it is fair to say that we do not know enough to make a judgment that the prices for the elderly, or for the products that the elderly consume, are rising faster.

You pointed out that a much higher fraction of the total consumption of the elderly is in medical care. And medical care is rising at a rapid rate. But we know something else. And that is that the CPI's measurement of the increase in cost of medical care is very very rough. It is terribly difficult to factor in the qualitative improvements in medical care.

Now the doctor has diagnostic tools and is capable of doing things that were undreamed of a decade ago. This is not the same service for a half hour's doctor visit. You are getting much more medicine, and you should make a correction for that.

Senator MOSELEY-BRAUN. I would like to take this one step further. And this was actually was inspired by some of Senator Rockefeller's questioning. It is not directly related to it but was inspired by it.

And that is the kind of cost-shifting that goes on between the Federal Government and the States with regard to health care for the elderly, particularly in light of the fact that long-term care is not covered under Medicare.

What you often find is that those individuals' costs of care get shifted to the States. Have you made an analysis of that? And, if so, to what extent do you think it impacts on our decisions on health, or should impact on our decisions concerning health care financing?

Dr. RESICHAUER. A lot of long-term nursing home care is picked up in the Medicaid program. Much is paid for by individuals, but a good deal is paid for by the Medicaid program.

Senator MOSELEY-BRAUN. But, particularly with regard to those people——

Dr. REISCHAUER. Excuse me.

Senator MOSELEY-BRAUN [continuing]. Particularly with regard to those people who are Medicare-eligible.

Dr. REISCHAUER. That is quite true. And that is a program in which the Federal Government provides open-ended matching for the costs that are incurred by the States. It ranges from 50 percent to about 80 percent of the cost.

So, it is true that some of the cost is borne by the States. But a very large portion of it is borne by the Federal Government in matching payments. And a good portion of it is borne by individuals, as they spend down their assets.

Senator MOSELEY-BRAUN. My only point is that do you consider that, is that part of the calculation of the transaction costs for that part of the calculations that you use?

Dr. REISCHAUER. In what? Certainly in our health estimates. Yes. That is taken into account.

Senator MOSELEY-BRAUN. Thank you.

The CHAIRMAN. Senator Pryor.

Senator PRYOR. Thank you, Mr. Chairman.

Mr. Chairman, I tried earlier today—I could not come over here, and I tried to watch Dr. Reischauer's statement on the Senate channel, and some very good questions and discussion by our colleagues, and then we had the two votes.

But I think this is a very important hearing. And we are glad that you called it.

The Bipartisan Commission on Entitlement and Tax Reform—we call it the Kerry-Danforth Commission, Dr. Reischauer—I think has rendered a real service to us. I think that what they have produced is respected, but maybe neglected sometimes, and sits on the shelf.

But one of the charts that came out in their August publication, I think, tells a story that we just cannot get away from, we cannot run away from. And that is, when you go back to 1963, mandatory spending was 30 percent, 29.6 percent. It was 30 percent in 1963. By the year 2003, it is going to be 72 percent—mandatory spending.

Our discretionary spending will be 28 percent, whereas in 1963 it was 70 percent. So we have seen this whole thing turn upside down. Of course, we are looking at entitlement issues.

As we proceed in the debate on the balanced budget amendment, and we are looking at discretionary spending being whittled down to about 25 to 28 percent of the funds that are going to be there to sort of help balance the budget, how are we going to, with that small piece of pie, find the funds to balance the budget in that particular year?

Dr. REISCHAUER. I do not think you can fund them out of discretionary spending, especially if you listen to the concerns that many of your colleagues have about defense spending, because defense spending constitutes about half of that discretionary spending.

Clearly, the major portion of the answer has to lie in the entitlement or tax areas. There is no escaping that.

Senator PRYOR. As sure as we are sitting right here, we are going to exclude Social Security. So let us say Social Security is excluded, and it probably should be. So what does that leave left then in entitlements—Medicare, Medicaid, veterans, interest? Well, no, not interest; that would be a separate thing.

Dr. REISCHAUER. That leaves you Medicare, Medicaid, civil service and military retirement, veterans' pensions and veterans' compensation, student loans, the farm price support system, AFDC, food stamps, SSI. How am I doing?

The CHAIRMAN. While he is looking, let me interrupt, David.

Senator PRYOR. You may have discussed this.

The CHAIRMAN. Well, we did not discuss this. There are about 410 entitlement programs.

The bottom 400, plus or minus, cost about $50 billion—the bottom 400, all of them put together.

Medicare, Medicaid, Social Security, and then other retirement—military retirement, civilian retirement, and interest—are $900 billion.

You can eliminate the 400. And the other four, plus interest, go up more each year, almost more than the entire 400.

I know where you are aiming. It is for the ducks.

Senator PRYOR. Where are they?

The CHAIRMAN. And if we are going to exclude all the duck ponds, where do we get the money?

Senator PRYOR. And I guess that is the question I am asking Dr. Reischauer.

Dr. REISCHAUER. If you are excluding all those ducks, I think you have to look over to the pond called revenues. [Laughter.]

Senator PRYOR. Well, I just think that this Commission report that they have done for us, I think is very good. And, somehow or another, I just cannot get away from it. And I look in the out-years, just a few years away, and seeing that what we are about to do excludes Social Security and perhaps others. And, as Senator Packwood, the Chairman says, where are the ducks?

And so I have gone duck hunting now. This time we will rest. I yield back my time.

The CHAIRMAN. We will go around again. I have no more questions.

Senator Moynihan?

Senator MOYNIHAN. I do. ~~And it~~ just is a question of how we use words, for those of us who are concerned about the Social Security system.

And this person is very concerned about the way in which we are using the word "entitlement". Frederick Clay has a lovely book on diplomacy, in which he uses the term "semantic infiltration".

If you can get an adversary in a negotiation to start using your words or terms for what you are talking about, you have made a great advance.

I think Ambassador Reischauer would probably agree that the Japanese did a brilliant job in persuading the world that they had invaded Manchuria, and not China.

Well, we just invaded Oregon. What the hell does that got to do with the U.S.? [Laughter.]

Dr. REISCHAUER. I will leave that to the Chairman.

Senator MOYNIHAN. It actually belongs to British Columbia. It really belongs to Canada anyway.

The CHAIRMAN. Fifty-four forty or fight.

Senator MOYNIHAN. Fifty-four forty or fight.

The use of the term "entitlement" describes a benefit conferred by government, but automatically received if you meet certain criteria, whether it is for food stamps or crop insurance, or whatever. That is one thing.

To start calling Social Security and Medicare an entitlement, in the same way that you refer to food stamps and agricultural price supports, or whatever, are we not confusing two categories?

Dr. REISCHAUER. There are actually a number of categories here. There are programs within the entitlement category that are known as social insurance, which individuals have paid contributions into, which makes them eligible for a benefit if certain circumstances occur; they retire at age 62, three, four, five, whatever, They become unemployed, and so on.

Then there are "means-tested entitlements," for which, obviously, nobody makes a contribution to attain eligibility.

Senator MOYNIHAN. Well, the vital distinction, surely, is between those——

Dr. REISCHAUER. Contributory and non-contributory programs.

Senator MOYNIHAN [continuing]. Contributory and non-contributory programs.

Dr. REISCHAUER. But I do not think we should suggest that in the contributory programs, the individuals receiving benefits, even in the aggregate, are receiving benefits worth just what they have contributed, or has been contributed on their behalf. In most cases, there is a very large subsidy added to the contributions that have been made on their behalf.

Senator MOYNIHAN. I am going to ask you to give us your views on that on paper, would you?

[The following was subsequently received for the record:]

The following gives the average annual Social Security and Medicare subsidy for beneficiaries who were 65 years old in 1992.

MEDICARE AND SOCIAL SECURITY SUBSIDIES

CBO estimates that for the average beneficiary who was 65 in 1992, expected lifetime Medicare and Social Security benefits exceed contributions to the Medicare and Social Security trust funds made by or on behalf of that beneficiary. The extent of the subsidy varies by the beneficiary's wage history and gender. The following tables show the average annual subsidy by program and category of beneficiaries. The subsidy was calculated by estimating the discounted lifetime contributions by an average member of a category (including contributions made on behalf of a worker by an employer) and subtracting that from the discounted value of the expected lifetime benefits for that beneficiary (a discount rate of 7 percent was assumed for both contributions and benefits). The annual subsidy was derived by dividing the lifetime subsidy for a category of beneficiaries by the average life expectancy for a member of that category. For Medicare, the annual subsidy was calculated for both the Hospital Insurance (HI) program, which is supported by social insurance taxes, and the Supplementary Medical Insurance (SMI) program, which is supported by premiums (which, under current law, cover about 25 percent of program costs) and general fund contributions. For Social Security, the estimates cover payroll taxes and benefits for the Old Age Insurance (OA) program.

MEDICARE AND SOCIAL SECURITY SUBSIDIES
FOR BENEFICIARIES WHO WERE 65 YEARS OLD IN 1992
(in dollars)

Medicare

	Self-Insured Men	Self-Insured Women	Spouse-Insured Women
Average annual HI subsidy			
For low contributions	2,201	2,214	2,651
For average contributions	1,718	1,832	2,651
For maximum contributions	580	934	2,651
Average annual SMI subsidy	2,157	2,273	2,273
Average annual total subsidy:			
For low contributions	4,358	4,487	4,924
For average contributions	3,874	4,105	4,924
For maximum contributions	2,737	3,207	4,924

Social Security

	Male Worker	Female Worker
Average annual OA subsidy		
For low contributions	2,235	2,484
For average contributions	2,097	2,758
For maximum contributions	1,045	2,333

Senator MOYNIHAN. Now, in the beginning of any retirement system, there is a great bonus.

And that lady from Vermont who was the first one to retire in 1940, and she paid in $18, and every January 1 there would be a picture of the nice man from Social Security giving this widow her check. And she lived to get back $7,000 on her $18.

But I think we are now at the point where the average worker is just about getting back what was put in. Can we get your reading on that?

Dr. REISCHAUER. I would disagree with that. I would say that——

Senator MOYNIHAN. I am not asserting. I said I think.

Dr. REISCHAUER [continuing]. That, I think, would be true for the younger cohorts, the people who are now, let us say, 35 or below.

I made a calculation of this sort. I want to emphasize that this is a crude set of numbers, but it was for a worker retiring in January of 1992 with an average wage during his or her lifetime. The value of the subsidy—which, in the case of Social Security, is being paid by current workers——

Senator MOYNIHAN. Yes.

Dr. REISCHAUER [continuing]. Which is really an intergenerational transfer, was around $2,000, year over and above the amount that they contributed.

For Medicare, it is even higher. We have to remember that in the Medicare program, the contributions have been very low and the costs have escalated very rapidly. There is also a Part B of that program which is non-contributory, but you have to pay a monthly premium. That premium is set at roughly 25 percent of the total cost, and 75 percent is provided by the general taxpayer.

Senator MOYNIHAN. Yes. Right.

Could I ask you, if you could, to take a look at that report?

Dr. REISCHAUER. I will be glad to.

Senator MOYNIHAN. Because I think you will find the Social Security actuaries see the subsidy disappearing much quicker than we thought.

It is that you are now going to get back just about what you put in, skewed because there is a deliberate higher rate of return for lower-income.

Dr. REISCHAUER. I am not arguing with you about the cohort of current workers. I am suggesting that this is true for the individuals who are retiring at age 65 right now. That is all.

Dr. MOYNIHAN. They think it is.

Dr. REISCHAUER. All right. We will look at it, and provide it for the record.

[See material supplied on the preceding pages.]

The CHAIRMAN. Senator Graham?

Senator GRAHAM. Thank you, Mr. Chairman.

I would like to return to the topic we were discussing earlier. And that is the impact of the Social Security surplus on the calculation of the deficit.

You indicated that, in the year 2002, the Social Security surplus would be $111 billion, but that surplus would have left us a deficit of $433 billion, rather than the $322 billion which you state.

Dr. REISCHAUER. Yes.

Senator GRAHAM. At some date, a decade or so after the year 2002, Social Security will reverse and become, rather than a surplus, will become a net draw down of resources. Is that a correct statement?

Dr. REISCHAUER. Yes. That is correct.

Senator GRAHAM. What will be the options that we will be faced with, let us say in the year 2015, when we are facing a deficit driven by the increasing draw downs from Social Security?

Dr. REISCHAUER. We will face the option of running larger deficits, cutting other spending, or raising taxes.

Senator GRAHAM. But we will have a Constitutional amendment which will mandate that we have a balanced budget, and it is a consolidated budget.

Dr. REISCHAUER. If that is the case, you will have to cut spending or raise taxes——

Senator GRAHAM. Well, we will already have——

Dr. REISCHAUER [continuing]. To make up for this deficit that will occur in the Social Security trust fund, although the trust fund at that point, of course, will be simply cashing in the assets that it has accumulated over the preceding 25 years.

Senator GRAHAM. We will have substantially reduced our discretionary and other entitlement—and I use that word generically—spending in order to get to the 2002 level. And, presumably, we would have to continue those restraints on discretionary and non-Social Security entitlement spending in order to stay at that level of balanced budget post.

Dr. REISCHAUER. Or you will have to raise taxes.

Senator GRAHAM. And then if we have in this Constitutional amendment a requirement of a super majority of the Congress in order to raise taxes, are we not building ourselves a very difficult box for the next generation to live with.

Dr. REISCHAUER. You would be very happy if there were term limits. Yes.

The choices that will be faced by Senators and Congressmen in that time period will be very very difficult.

Senator GRAHAM. Could you provide us with the numbers of the Social Security surplus or deficit beyond the year 2002.

Dr. REISCHAUER. We only project them ourselves through the year 2005. But I certainly will get for you the numbers that the Social Security system provides.

Senator GRAHAM. Thank you.

[The following information was subsequently received for the record:]

CBO does not project the Social Security Trust Fund balances beyond 2005. The following table shows the most recent projections by the Social Security Administration.

02/15/95

OLD-AGE AND SURVIVORS INSURANCE AND DISABILITY INSURANCE TRUST FUND BALANCES

(In billions of current dollars)

Year	Assets (EOY)	Surplus
1994	430.9	
1995	490.5	59.6
1996	555.1	64.6
1997	624.2	69.1
1998	697.8	73.5
1999	776.4	78.7
2000	861.1	84.7
2001	951.8	90.7
2002	1048.2	96.4
2003	1151.3	103.1
2004	1262.4	111.1
2005	1382.9	120.5
2006	1513.4	130.5
2007	1653.0	139.6
2008	1800.1	147.1
2009	1952.1	152.0
2010	2107.5	155.4
2011	2264.0	156.5
2012	2417.0	153.1
2013	2562.9	145.9
2014	2697.5	134.6
2015	2815.8	118.3
2016	2913.4	97.6
2017	2983.4	70.0
2018	3020.4	36.9
2019	3019.6	-0.8
2020	2975.9	-43.7
2021	2882.8	-93.1
2022	2734.6	-148.2
2023	2525.1	-209.5
2024	2247.2	-277.9
2025	1894.2	-353.0
2026	1460.1	-434.1
2027	938.9	-521.2
2028	325.8	-613.2
2029	-384.1	-709.8
2030	-1198.2	-814.2

Year	Assets (EOY)	Surplus
2031	-2122.9	-924.7
2032	-3166.3	-1043.4
2033	-4335.5	-1169.2
2034	-5637.6	-1302.1
2035	-7079.4	-1441.8
2036	-8665.8	-1586.5
2037	-10407.8	-1742.0
2038	-12315.3	-1907.5
2039	-14399.2	-2083.9
2040	-16677.8	-2278.6
2041	-19165.7	-2487.9
2042	-21883.7	-2718.0
2043	-24848.5	-2964.8
2044	-28084.5	-3236.0
2045	-31617.3	-3532.7
2046	-35475.5	-3858.2
2047	-39685.8	-4210.3
2048	-44281.1	-4595.3
2049	-49297.4	-5016.4
2050	-54774.2	-5476.8
2051	-60755.5	-5981.3
2052	-67289.8	-6534.3
2053	-74425.2	-7135.4
2054	-82212.3	-7787.2
2055	-90707.4	-8495.1
2056	-99967.3	-9259.9
2057	-110052.3	-10085.0
2058	-121027.5	-10975.2
2059	-132963.1	-11935.6
2060	-145927.8	-12964.7
2061	-160007.4	-14079.7
2062	-175280.1	-15272.7
2063	-191838.5	-16558.4
2064	-209774.5	-17935.9
2065	-229194.7	-19420.2
2066	-250212.7	-21018.0
2067	-272948.2	-22735.5
2068	-297530.5	-24582.3
2069	-324103.6	-26573.1
2070	-352818.8	-28715.2

SOURCE: Social Security Administration, April 1994 Annual Trust Fund Report

Note: These numbers are in current 1994 dollars. They will differ from CBO's estimate from 1995 to 2005 because CBO's estimate is in nominal dollars. Further, CBO's estimate was made January 1995, whereas this estimate is from April 1994.

Senator GRAHAM. A second question. Senator D'Amato raised some questions about Mexico, and he quoted the first paragraph of box 1–2 on page 11 of your Economic Outlook.

He quoted the first part of the sentence, which states, "Although the crisis is likely to have significant effects on the Mexican economy, the overall effect on the U.S. economy will be small, particularly if stabilizing measures and reforms prove successful."

How would you restructure that sentence if the words after that last comma were eliminated, if there were no stabilizing measures or reforms initiated? What could be the effect of the Mexican economy on the United States?

Dr. REISCHAUER. We are dealing here with a situation that has a great deal of uncertainty in it.

If the United States or some international agency does not provide some form of loan guaranty or mechanism for the Mexicans to get back into international credit markets at reasonable prices, the Mexicans will have to tighten their belts a lot more. The value of the peso might go down even more. The economic contraction within Mexico would be even greater.

Nevertheless, we are dealing with an economy that is basically sound. It is going through some difficult times, but Mexico has adopted political and economic reforms, deregulation, selling of government enterprises, privatization of one sort or another, evolution towards a multiparty democracy from a one-party State. And Mexico has a government that is not running large budget deficits the way we are.

This is not a bankrupt country. It is a country that, in a sense, had a cash flow problem, faced a temporary currency crisis. If there is no overreaction by credit markets, if there is no panic, the impact should not be very large on our economy, as I explained before.

There is always a very small probability that things could come unraveled in a more serious way. There could be political instability as a result of the necessary economic retrenchment. The international capital markets could get extremely skittish and not just withdraw funds from the Mexican economy but also from other developing economies.

I think the probabilities of that are fairly small. We really are talking about our best judgment of how things are likely to evolve. We did not go into all the possible scenarios, either on the plus or the negative side, that could occur.

Senator GRAHAM. Thank you.

The CHAIRMAN. Senator Moseley-Braun. And then Senator Conrad.

Senator MOSELEY-BRAUN. Thank you very much, Mr. Chairman.

Dr. Reischauer, I was delighted that Senator Pryor raised the Bipartisan Commission on Entitlement and Tax Reform. And I guess my first question ought to get right to the point. At the end of the report there is a list of the sources and assumptions. And I guess my first question to you would be, do you agree with these sources and assumptions? Number one, and, number two, is there anything that the Commission did not touch on that, in your opinion, should have been addressed?

Dr. REISCHAUER. I do not have the list of assumptions.

We communicated with the staff of that commission and tried to be helpful. Our feeling was that that staff was very competent, relying on accepted methodologies and accepted data. There is a lot of uncertainty about what the world is going to look like 20 or 30 years from now. And it is a period of time that we do not try to forecast. But I think, on the whole, that they did a very responsible job.

Senator MOSELEY-BRAUN. And so, again, there are only seven assumptions. I mean, I can read them to you. I guess the point I am trying to get to is whether or not there were areas that should have been covered in the assumptions underlying the Commission's work.

Dr. REISCHAUER. I can give you just one caution and that is Herb Stein's dictum, namely, those things that cannot continue will not.

We cannot have a situation in which medical spending absorbs greater and greater fractions of our National income or, by the middle of the next century, we will consume nothing but medical care. And we know that is not going to happen.

Senator MOSELEY-BRAUN. Right. Senator Moynihan used the term "semantic infiltration". I had heard it before, but I like the idea because, if anything, with regard to the work of this Commission, one of the things that kind of concerned me was the Commission's interest in talking about the spending side of the equation. And there was less readiness to talk about the revenue side of the equation.

And, in that regard, without waving the flag of tax increases at people, the question is, in your opinion, would it make sense to spend a little more time and attention on tax expenditures, what in the popular parlance might be called tax loopholes or taxes foregone by the Government, looking at the revenue side of the equation as part of our analysis of the drive path for a balanced budget?

I say that because, in your statement here, you talked about a possible approach to achieving a balanced budget. But I did not see, when I looked at table 5, and I have really lost the page. When I got to table 5——

Dr. REISCHAUER. We carefully labeled those as policy changes which, presumably, could subsume tax increases as well as mandatory spending cuts. That is really a choice that you and your colleagues have.

Senator MOSELEY-BRAUN. Well, I guess that is exactly the question I was going to get to. Because you say in a footnote, under "policy changes", that these changes represent only one of a large number of possible paths that would lead to a balanced budget.

Now that exact path depends on when deficit reduction begins and the specific policies adopted by the Congress and the President.

Have you written any possible paths, any possible alternatives, that would include both revenue and spending kinds of approaches?

Dr. REISCHAUER. We have been vague in the sense that that path could accommodate tax increases and spending cuts. That is up to the Congress to decide. If it liked the path, it could decide on the specific policies that made up that needed amount of deficit reduction from policy changes.

Senator MOSELEY-BRAUN. That was my question, whether there was anything around that was less vague than what you have.

Dr. REISCHAUER. No. We really cannot. We wait for guidance from you.

Senator MOSELEY-BRAUN. Oh, thank you.

And then finally, are you familiar with Budget Shadows?

Dr. REISCHAUER. No.

Senator MOSELEY BRAUN. All right. The Entitlement Commission staff put together——

Dr. REISCHAUER. Oh, oh. The computer game. Sure. No. I have not played it, but I have the disks. I have not loaded them onto my computer. I spend enough time making myself depressed with these numbers anyway. I do not need a game to rub it in even more. [Laughter.]

Senator MOSELEY-BRAUN. I just asked the question. I have given it to my son, Mr. Chairman. There is a game of Sim-City and Sim-Earth, in which you become the Emperor of the world or the mayor of a city. You have to balance these budgets, and make all these things work. So I have given Budget Shadows to Matthew with the hope that maybe he can work this out, since it is his generation that will need it.

The CHAIRMAN. We do it by taking care of Congressional pensions.

Senator MOSELEY-BRAUN. Right.

The CHAIRMAN. Senator Conrad?

Senator CONRAD. Thank you, Mr. Chairman.

I want to welcome Dr. Reischauer. I assume this may be his last appearance, or one of his last appearances. And I just want to publicly thank Dr. Reischauer for his commitment and his professionalism. I think it is rare that a CBO head leaves with his credibility fully intact.

Dr. REISCHAUER. I had better leave fast.

Senator CONRAD. Dr. Reischauer, I do believe that you leave with your credibility fully intact. I think that you have been honest and nonpartisan. I think you have really gone the extra mile to be of service to the Congress and to the American people.

I just want to publicly acknowledge the excellent work you have done and wish you well for the future. Whoever is going to get your services is very lucky. And I think we are fortunate to have had them. I think it is a real loss that you will be leaving.

Dr. REISCHAUER. Thank you.

Senator CONRAD. I just wanted to put up a chart. Perhaps this has been covered, and I apologize. I have had three committee meetings simultaneously this morning.

That chart shows, according to your most recent estimate, the hole that has to be filled in over the next 7 years if we are going to balance the budget. It is $1,035 trillion. It is not million, it is not billion, it is trillion. It is real money. A trillion, thirty-five billion dollars. That is $1,035 trillion.

And the Republican Contract for America, according to Treasury, proposes $364 billion of tax cuts before we start filling in this gap which, of course, would take us to nearly $1.4 trillion.

Do we have that chart? The blue bar becomes the $1,035 trillion we have to close in the next 7 years if we are going to balance the budget.

The orange bar shows the $364 billion, according to Treasury Department, that the Contract for America would cost in tax cuts.

And the red bar is $82 billion of increased defense spending called for in the Contract for America. That gives us a grand total of $1,481 billion that would be necessary to cut over the next 7 years.

I just wanted to ask you, Dr. Reischauer, do you think it makes sense to have a tax cut in light of these numbers?

Dr. REISCHAUER. I have survived the last 6 years by not answering that kind of question.

I think the Congress should decide which has higher priority, reducing the deficit or reducing the tax burden on the American people, and then pursue the objective that has the highest priority.

These are in conflict, as you point out. I think the Republican leadership, as well as the President, has every intention of paying for the tax cuts that are being proposed through spending reductions.

But, presumably, each incremental spending reduction one engages in is harder to get through the Congress, and it is harder to get through the Congress because it has more serious impacts on the American economy, on the constituencies, on the objectives that we have as a nation.

As you suggest, if a big chunk of spending cuts is needed to pay for tax reductions, then the spending cuts that will be required to balance the budget will be all the more difficult to achieve.

Senator CONRAD. Could I ask you, in your professional judgment, in terms of economic effects, is it more important to be reducing the deficit, or more important to be giving tax reductions at this time?

Dr. RESICHAUER. I answered that question earlier by saying that the most important task before this Nation is to strengthen the economic situation and living standards in the long run.

One can argue that that can be achieved by reorienting our tax and spending system within a constant fiscal policy or by reducing the deficit and increasing the national saving rate.

I would opt for the latter of those two, in large measure because we have not been particularly successful in the past when we have tried to change tax and spending policy, as well as adopting programs which have a significant impact on potential growth of the economy.

Senator CONRAD. Well, I thank you for that.

The CHAIRMAN. I asked him almost the same question earlier on. And I think I phrased it, if our theory is that we are going to pay for these tax cuts with spending cuts, then we do nothing for the deficit. And I posed the question as to which would be more important, assuming we have the spending cuts. And he said reducing the deficit. That assumes we get the spending cuts.

Senator CONRAD. Well, I thank the Chairman for that observation. I thank Dr. Reischauer. And, again, I very much appreciate the public service that you have provided.

The CHAIRMAN. Senator Nickles?

Senator NICKLES. Mr. Chairman, thank you very much. And, Dr. Reischauer, thank you. I appreciate your patience. Mr. Chairman, I will apologize to you. I had hoped to talk to Dr. Reischauer yesterday, but I had to leave right before my time in the Budget Committee. So I will do a little bit of that today.

I might mention though, in Senator Conrad's chart, it shows $1.4 trillion in deficit reduction needed to balance the budget. Over those same years, I believe in that same period of time, we are going to be spending about $15 trillion.

Senator CONRAD. Thirteen trillion. Yes.

Senator NICKLES. So I think it is important that we compare what we are talking about. People talk about the magnitude of the cuts, or the magnitude of the tax increases, and so on. And it sounds like it is so large, you have to compare it with how much you are anticipating to spend over that period of time. Fifteen trillion dollars is a pretty good amount of money.

The CHAIRMAN. Don, could I ask this? Could you close up for me? I have a 12:00 o'clock appointment.

Senator NICKLES. I would be happy to.

The CHAIRMAN. Doctor, let me echo everything that everybody has said about you. It has been a privilege working with you. I wish you luck wherever you go. You have always been a square shooter with me, and I am eternally grateful.

Dr. REISCHAUER. Thank you.

The CHAIRMAN. You bet.

Senator NICKLES. Senator Packwood, thank you very much.

Dr. Reischauer, a couple of things I think are important. I have enjoyed working with you. Also, I am one of these very unusual people. I actually read a lot of your information that comes out of CBO, and particularly your Economic and Budget Outlook for the years.

I know that we spend a lot of time in the Budget Committee going over baselines, discussing baselines, and cussing baselines.

I remember—and I hope my staff gave you a copy of this chart I am going to talk to you about a little bit.

[The chart referred to follows:]

SOURCE OF DEFICIT DECLINE

Since President Clinton Took Office

	Clinton Term				Out Years		
	103rd Congress		104th Congress		105th Congress		
	1993	1994	1995	1996	1997	1998	TOTALS
CBO Deficit Baseline (January 1993)	310	291	284	287	319	357	1,848
Tax & Fee Increases	0	(28)	(46)	(56)	(66)	(66)	(262)
Spending Increases/(Cuts)	4	9	3	(15)	(36)	(53)	(88)
Technical, Economic, & Other *	(59)	(70)	(65)	(9)	5	(15)	(213)
CBO Deficit Baseline (January 1995)	255	203	176	207	224	222	1,287

Details may not add due to rounding.
Amounts which reduce the deficit are shown in (parenthesis).
* = Includes technical re-estimates, economic changes, and net interest changes.
Sources: CBO Reports (March 1993, September 1993, January 1994, April 1994, August 1994, January 1995)

Senator NICKLES. We reviewed the baseline that you presented before the Budget Committee in January of 1993. And it estimated the total amount of deficit over those 5 years at, I think $1.8 trillion. And then the one that you just submitted to Congress this January is about $1.2, almost $1.3 trillion. That is a reduction in the CBO baseline deficit for those number of years by almost $600 billion.

I notice the President, in his State of the Union message, has a quote. He says, "We cut the deficit by over $600 billion." That sounds really good to the American people. We cut the deficit by $600 billion. I wanted to figure out what the differences were between the baseline in January of 1993 and the baseline in 1995, and how much of that was done by tax increases? How much of that was done by spending increases? And how much was done by reestimation by CBO and by your economists, due to reestimation of interest rates and the economy, and so on?

Our staff put this together by going back and looking at your charts. My staff shows me that, of that difference, it shows that tax and fee increases are $262 billion over that time frame. Spending cuts, net, over that same time frame of the 6 years, $88 billion, and technical and economic and others, $213 billion.

So, in looking at all the combined total, we have spending increases "262", tax cuts of "88", and technical and other of "213". Have you had a chance to confirm these? And, if you have not, I will be happy to give you some time, or you can submit those.

Dr. REISCHAUER. We will look through this. It looks approximately right. It could be exactly right. I am not arguing that. But just from our quick look, this seems to be close to the story that changed economic and technical assumptions, had a major impact, and that revenue increases were a substantial part of the deficit reduction packages that were passed both in 1990 and in 1993, although the 1993 package was certainly much more heavily weighted toward revenue. It was something like 62 percent, I believe, of the savings associated.

You have included, I believe, in this chart—and the reason that I cannot come up with a quick answer—fee increases that often are included in the outlay side of the budget as negative outlays. They are increases in charges for business-type activities that the Government engages in. We do not wrap up the numbers quite that way. I do not think you have included in here—although I could be wrong—the changes that are brought about by reduced debt service. When the deficit goes down, debt service is reduced.

Senator NICKLES. I do not think that changes the story at all.

Dr. REISCHAUER. I am adding a few footnotes here, rather than trying to argue with your general conclusions, which I think are correct.

Senator NICKLES. We put the debt service changes in technical and economic because that was not actually a policy change.

Dr. REISCHAUER. But it does relate to the changes in policy. When you bring the deficit down, you——

Senator NICKLES. I understand.

Dr. REISCHAUER [continuing]. Have less debt that you are paying interest on.

Senator NICKLES. When you check this out, if you want to put another line in for interest savings, that is fine with me.

My point is too, and I would like for you to confirm or give us figures, our charts show that the administration's changes actually show spending increases in 1993, 1994 and 1995. The spending cuts are programmed to go forward in 1996, 1997 and 1998. I would be interested if you would confirm that as well.

Senator NICKLES. But anyway, you know what we are trying to do by this chart. If you would review it, improve upon it, I would appreciate that because I think it is important.

[The following information was subsequently received for the record:]

The following table shows how much of the change in CBO's deficit estimates since August 1993 is the result of legislation (with those effects broken down by changes in revenues, changes in offsetting receipts, changes in other spending, and changes in interest resulting from these policy reductions) and how much is the result economic and technical reestimates.

CHANGES IN CBO DEFICIT PROJECTIONS SINCE JANUARY 1993
(by fiscal year, in billions of dollars)

	1993	1994	1995	1996	1997	1998	1993-1998
CBO January 1993 Baseline Deficit	310	291	284	287	319	357	na
Policy Changes							
Revenues \a	0	-26	-44	-50	-59	-57	-237
Offsetting receipts	0	-2	-3	-4	-6	-7	-22
Other spending	4	9	3	-16	-38	-56	-94
Debt service on policy changes	b	-1	-3	-6	-12	-20	-42
Subtotal	4	-20	-46	-77	-115	-140	-395
Economic Changes	-0	-21	-13	7	11	1	-15
Technical Changes	-59	-47	-49	-9	8	4	-152
Total Changes	-56	-88	-108	-79	-96	-135	-562
CBO January 1995 Baseline Deficit \c	255	203	176	207	224	222	na

SOURCE: Congressional Budget Office

NOTES:
a. Revenue increases are shown with a negative sign because they reduce the deficit.
b. Less than $500 million.
c. Assumes discretionary spending lcomplies with limits through 1998 and grows at the rate of inflation after that.

na = Not applicable

Senator NICKLES. The President also said in the State of the Union message that we cut over a quarter of a trillion dollars in spending.

That statement bothers me. I think it is very misleading. And particularly, if this chart is correct, administration actions the first 3 years increased spending, not decreased it. We will have to see what happens in 1996, 1997 and 1998.

He is taking credit for all that. But even if you give him all that, according to our calculations, he should only have a total of $88 billion. And again, spending increases in the first 3 years, spending cuts are programmed for the future.

In addition to that, ask him if he is talking about extending the discretionary freeze for 2 years, and that is in the way out 2 years. I am trying to figure out what 2 years that would be.

Dr. REISCHAUER. Nineteen ninety-nine and 2000, I think.

Senator NICKLES. Taking credit for those savings, I think, is more than hypothetical, and maybe a little misleading.

Plus I am bothered. I have always talked to you and others about baselines. When I hear the President of the United States say, "We cut over a quarter or a trillion dollars in spending", and we were spending $1.4 trillion in 1993 and $1.46 trillion in 1994, that is an increase. In this year, 1995, it is $1.53 trillion. Next year it is $1.62 trillion. The following year it is about $1.7 trillion. I do not see any cuts. I see increased spending every year, if you are going by total amount of money that we spend. I think that is misleading as well.

So, if you could at least confirm my charts, I think that would be helpful.

I really do want truth in budgeting. I really want people to talk about the same numbers. By having the President say that we reduced the deficit by $600 billion, and slashed all those program, the impression people have is that we cut Federal spending by $600 billion.

My charts say that his administration's first three years increased spending. And the next 3 years is speculative at best. I would just appreciate knowing the facts and figures. Your shop has been good at providing those, and I thank you for that.

Dr. Reischauer, a couple of other quick things. We are going to be debating the Constitutional amendment to balance the budget very soon. Some people are advocating that we have significant exceptions to that balanced budget amendment. Let us exempt social programs, let us exempt Social Security, or let us exempt Medicare.

Would it make sense, if we had a Constitutional amendment to balance the budget, to have such an exception in the Constitution?

Dr. REISCHAUER. Starting with your premise, which is if we have one, I would say that the most comprehensive treatment of the budget would be the most desirable. And what you want is a situation in which all activities of the Federal Government are always on the table to increase or decrease. We do not know how this country, the economy, or the world situation is going to evolve. In 1920, there was no such thing as Social Security. Now there is. Who knows what the world will look like in 2020.

If you are going to lock something into the Constitution, you want to do what our founding fathers did, which was provide guidance, general guidance, not nitty gritty specificity, so that the amendment will have enduring value.

Senator NICKLES. I concur with that. And I appreciate your thought.

Also, there are proposals—you are an economist by trade—that are advocating a significant increase in the minimum wage, like 18 percent.

Is it your belief that, if you had such an increase, there would be some increase in unemployment, some loss of jobs?

Dr. REISCHAUER. There are a number of studies that have recently been done that suggest that, now that the minimum wage is low compared with its historical level—in real terms or relative to average wage—that the disemployment impacts of raising the minimum wage would be very small. I believe that, nevertheless, they would be positive; that if we raised the minimum wage, some jobs would be lost.

Senator Nickles. Have you done any studies that indicate the percentage of people who are making minimum wage and are classified as poor, in poverty status?

Dr. REISCHAUER. Yes we have. I am afraid I cannot pull the number right out of my head. It is something like 30 percent, I believe, of family units that are below the poverty level. But I will provide the exact number for the record.

Senator NICKLES. If you would. I think it is even less than that. And I am stretching my memory as well. But if my daughter, who does work for minimum wage—is living in a household that is not in minimum wage—she is not in a poor status. I think it is closer to, I want to say, 67 or 80 percent. It is a high percentile.

Dr. REISCHAUER. If you asked me for a point estimate, and held me up against the wall with a gun, I would say 27 percent, which would be close.

Senator NICKLES. If you have that. I do not want an expensive study.

Dr. REISCHAUER. No. It is something that we have written about and published. I was actually looking at some material yesterday, a draft of a book by some economist at Princeton, that has some new tabulations of this sort. So it is a readily available statistic.

Senator NICKLES. Great. I would appreciate that if you could update it for myself and other members of the Committee because this may come before the Congress as well.

[The following information was subsequently received for the record:]

The following table shows CBO's most recent estimates of the breakdown of minumum wage workers by family income.

WORKERS PAID HOURLY RATES, BY FAMILY INCOME, MARCH 1993

		Wage Rate Paid in March 1993			
Characteristic	Total	Below $4.25	Exactly $4.25	$4.26-$5.25	Over $5.25
		Number of Workers (In thousands)			
Total	60,520	1,530	2,740	9,220	47,040
Family Income in 1992					
Below poverty	4,110	130	530	1,440	2,010
100-149 percent of poverty	5,060	260	340	1,200	3,250
150 percent or more	51,350	1,130	1,870	6,570	41,770
		Percent Distribution Within Each Wage Group[a]			
Total	100.0	100.0	100.0	100.0	100.0
Family Income in 1992					
Below poverty	6.8	8.5	19.2	15.7	4.3
100-149 percent of poverty	8.4	17.2	12.3	13.0	6.9
150 percent or more	84.9	74.3	68.5	71.3	88.8
		Percent Distribution Within Each Income Group[a]			
Total	100.0	2.5	4.5	15.2	77.7
Family Income in 1992					
Below poverty	100.0	3.2	12.8	35.1	48.9
100-149 percent of poverty	100.0	5.2	6.7	23.8	64.4
150 percent or more	100.0	2.2	3.6	12.8	81.3

SOURCE: Congressional Budget Office tabulations of data from the March 1993 Current Population Survey.

a. Percentages were calculated based on estimates prior to rounding.

Senator NICKLES. Dr. Reischauer, I join my colleagues in saying that it has been a pleasure working with you for the past several years. On the Budget Committee, you have provided us good advice and counsel. We appreciate your fine efforts.

Dr. REISCHAUER. Thank you. I have enjoyed it.

Senator NICKLES. Thank you very much. We will adjourn now.

[Whereupon, at 12:09 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED

PREPARED STATEMENT OF ROBERT D. REISCHAUER

Chairman Packwood, Senator Moynihan, and Members of the Committee, I am pleased to be with you this morning to review the state of the economy and the budget. Next week the Congressional Budget Office (CBO) will publish *The Economic and Budget Outlook: Fiscal Years 1996–2000,* which describes our current views in considerable detail. We have provided advance copies for the Committee.* My testimony summarizes that report. It also addresses a question about the difference between the budget and economic outlook in that report and the outlook in reports CBO issued before the Economic Recovery Tax Act of 1981 was enacted.

No fundamental change in the economic or budget situation has occurred since CBO published *The Economic and Budget Outlook: An Update* in August 1994. The economy may be a bit more robust in 1995 than had been anticipated at that time, but a likely slowdown in growth in 1996 leaves the long-term economic outlook little different from last summer's. CBO expects that the high levels of business investment and purchases of durable goods that spurred the economy to a 3.7 percent real rate of growth in 1994 will continue into the first part of 1995. Because the economy is already operating close to its potential (the level of gross domestic product, or GDP, consistent with a stable rate of inflation), that growth is expected to result in somewhat higher rates of inflation and interest. In turn, those higher interest rates are likely to slow growth by the end of 1995—cutting it to 2.5 percent in 1995 and 1.9 percent in 1996 and dampening inflationary pressures. In CBO's longer-term projections, average annual growth after 1996 is close to the 2.4 percent rate of growth estimated for potential GDP; over the 1997–2000 period covered by those projections, inflation averages 3.4 percent and interest rates drift down.

CBO projects that the deficit will decline from the $203 billion registered in 1994 to $176 billion in 1995, the lowest level since 1989 and the lowest as a percentage of GDP (2.5 percent) since 1979. After reaching a trough in 1995, the deficit will rise to $207 billion in 1996 (2.8 percent of GDP), grow again in 1997, and then level off in 1998. Those projections assume no change in current policies governing taxes and mandatory spending; they also assume compliance with the limits on discretionary appropriations that are in place through 1998. Under the assumption that spending for discretionary programs increases at the rate of inflation after 1998, deficits will grow to $284 billion (3.1 percent of GDP) in 2000, the last year of CBO's regular projections. Under an alternative baseline that assumes that discretionary spending remains frozen at the dollar level of the 1998 caps, deficits increase only to $243 billion in 2000.

CBO's extended projections for 2001 through 2005, which are less detailed than those through 2000, show deficits continuing to mount in dollar terms through 2005 if discretionary spending is adjusted for inflation after 1998 (see Figure 1 at the end of this statement). Deficits also grow as a percentage of GDP—to 3.6 percent in 2005. There is no reason to believe that this trend will be reversed in the years after that; indeed, the growth in the deficit is likely to accelerate in the second decade of the 21st century as large numbers of baby boomers become eligible for Social Security and Medicare benefits. Extended baseline projections that assume that discretionary spending is frozen at the 1998 level show deficits that are nearly constant from 2000 through 2005. As a percentage of GDP, the deficit in that baseline shrinks from 2.7 percent in 1998 to 2.1 percent in 2005.

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*This document was made a part of the official files of the committee.

Higher-than-anticipated interest payments and lower revenues, which are only partially offset by lower spending for medical care programs, have pushed up CBO's deficit projections for fiscal years 1995 through 1999 from last August's estimates by an average of almost $25 billion a year. After 2002, however, the deficits in the new extended projections are a little lower than the deficits projected in August.

The Congress is considering a constitutional amendment, which could go into effect as early as 2002, requiring a balanced budget. CBO currently projects a deficit of $322 billion for that year (assuming that discretionary spending is adjusted for inflation after 1998), which is only $3 billion more than the amount estimated last August. To illustrate the magnitude of the task facing those who would have to enact policies to comply with the balanced budget requirement, CBO has constructed an illustrative path leading to a balanced budget in 2002 that entails deficit reduction of $1.2 trillion over the 1996–2002 period. Major changes in current policies would be required to achieve deficit reduction on that scale.

THE ECONOMIC OUTLOOK

CBO forecasts that the strong economic growth that the nation experienced throughout 1994 will continue into the first part of 1995. Because the economy is operating close to its potential, that growth will increase inflationary pressures and is likely to trigger additional efforts by the Federal Reserve Board to rein in the economy with higher short-term interest rates. In the CBO forecast, the resulting moderate slowdown at the end of 1995 and during 1996 will gradually bring GDP back in line with potential output without seriously disrupting the economy. Even with somewhat higher short-term growth and the slowdown in 1996, the current economic projections for 1997 through 1999 are little different from those CBO made last August.

The Forecast for 1995 and 1996

The robust growth that the U.S. economy experienced in 1994 is likely to continue through the first part of 1995 but will fade by the end of the year. The 3.7 percent increase in real output (on a fourth-quarter-to-fourth-quarter basis) and the creation of over 3 million new jobs in 1994 were achieved without an increase in inflation, but that performance is not likely to be repeated in 1995 (see Table 1). Because the economy is already operating close to its potential, it cannot persistently expand faster than the growth of potential output—estimated at 2.4 percent a year by CBO—without triggering modestly higher inflation.

The Federal Reserve, which is determined to avoid any significant increase in inflation, raised the federal funds rate by 250 basis points (2.5 percentage points) in 1994 and is likely to further boost short-term interest rates in 1995. CBO forecasts that 90-day Treasury bill rates will average 6.2 percent in 1995—up from 3.2 percent in the first quarter of 1994. Rates for 10-year Treasury notes are expected to increase more modestly. The high rates of business investment and personal consumption of durable goods that drove the economy forward in 1994 apparently have not yet declined and will keep growth strong in the first part of 1995. However, by 1996, the cumulative effect of past and future hikes in interest rates should begin to bring the economy back in line with potential output. As a result, CBO expects that growth of real GDP will slow to 1.9 percent in 1996.

Unemployment will remain low in 1995—it is forecast to average 5.5 percent, compared with 6.1 percent in 1994—but will climb to 5.7 percent in 1996. Even at 1996's slightly higher level, unemployment will be below CBO's estimate of 6.0 percent for the nonaccelerating inflation rate of unemployment (NAIRU). A sustained unemployment rate below the NAIRU indicates a future increase in wage inflation. With unemployment below the NAIRU and GDP exceeding potential output, inflation is expected to rise in 1995 and 1996. Because the economy has not become too overheated and is expected to cool down later this year, the forecast upswing in the consumer price index for all urban consumers (CPI-U) is modest—from 2.8 percent in 1994 to 3.2 percent in 1995 and 3.4 percent in 1996 (see Table 1).

CBO's forecast assumes that the recent and anticipated future increases in short-term interest rates engineered by the Federal Reserve will restrain the economy to an appropriate degree. If the continuing strong growth that CBO foresees in early 1995 does not take place—if the economy has already started to cool off—the expected additional monetary tightening will slow growth sooner and more sharply than anticipated. Alternatively, if the economy proves stronger and more resistant than expected to the anticipated increases in interest rates and it surges well above potential output, the Federal Reserve will probably respond with even higher interest rates to combat the risk of inflation. That stronger-than-expected growth and the Federal Reserve's response to it could usher in a cycle of boom and bust for the economy.

Some economists argue that potential output may be greater than CBO estimates, in which case the economy could grow at its current rate for some time without triggering higher inflation. The Federal Reserve, however, is unlikely to allow such growth unless the evidence for a shift in potential output is more compelling than it currently is.

Projections for 1997 Through 2000

CBO attempts to forecast the cyclical fluctuations in the economy only for the next two years. Beyond 1996, its projections are based on trends in fundamental factors that determine the potential growth of the economy, including growth in the labor force, productivity, and national saving.

CBO's projections follow a path that has the gap between GDP and potential GDP reaching its historical average level—with GDP 0.6 percent below potential—at the end of the projection period in 2000. Because CBO estimates that the level of GDP will exceed potential output in 1996, the average annual real growth projected for 1997 through 2000 is slightly below the estimated 2.4 percent rate of growth of potential output (see Table 2). Unemployment is expected to increase slightly to 6.0 percent, the estimated level of the NAIRU. Projected consumer price increases are assumed to average 3.4 percent a year over the period, with projected interest rates declining from the levels associated with efforts to slow the economy in 1995 and 1996.

THE BUDGET OUTLOOK

Although CBO now projects that the deficits for fiscal years 1995 through 1999 will be almost $25 billion a year higher, on average, than it anticipated last August, the fundamental budget outlook is not very different from the one CBO projected then. Moreover, there has been no substantial change in CBO's deficit projections since its report in September 1993, which for the first time reflected the more than $400 billion in deficit reduction enacted in the Omnibus Budget Reconciliation Act of 1993 (see Figure 2). The deficit is still expected to fall in 1995 to its lowest level since 1989 and its lowest point as a percentage of GDP since 1979. As was also the case in August, the deficit is projected to begin rising again in 1996. CBO's extended budget projections show that trend continuing through 2005 if spending for discretionary programs increases at the rate of inflation after 1998. After 2002, currently projected deficits are slightly lower than the deficits forecast in August.

The Outlook for the Deficit

Since 1992's record-high shortfall of $290 billion, the deficit has declined to $255 billion (4.0 percent of GDP) in 1993 and $203 billion (3.1 percent of GDP) in 1994. (Although a record in dollar terms, the 1992 deficit as a percentage of GDP was far short—at 4.9 percent—of even a postwar record.) CBO projects that the deficit will decline for a third straight year to $176 billion (2.5 percent of GDP) in 1995 (see Table 3). That gratifying trend is expected to end next year, however, with the deficit climbing under current laws to $207 billion (2.8 percent of GDP) in 1996 and $224 billion (2.9 percent of GDP) in 1997 before leveling off in 1998.

The standardized-employment deficit, which is an estimate of the deficit that would occur if the economy was operating at its potential, is of interest because it is a measure of the fiscal posture of the federal budget without the cyclical effects of the economy. When the economy is operating below potential, the deficit swells as a result of reductions in revenues and increased spending for programs such as unemployment insurance. When the economy is operating above potential, revenues are increased and spending is lower. Because in CBO's forecast the economy will be operating close to potential throughout the 1995–2000 period, the projected standardized-employment deficits differ little from the projected total deficits. Despite that, a look at the standardized-employment deficit as a percentage of potential GDP is still illuminating. That measure varies only slightly from year to year during the 1994–1998 period, which makes it clear that the fiscal stance of the budget changes hardly at all during that time.

CBO's baseline projections for mandatory spending programs and taxes represent the outlays and revenues that will result if no changes are made in the laws governing those parts of the budget. The projections for discretionary spending (spending controlled by annual appropriations) assume compliance with the discretionary spending limits for 1996 through 1998 established for general-purpose appropriations in the Balanced Budget and Emergency Deficit Control Act of 1985 and for specific anticrime appropriations in the Violent Crime Control and Law Enforcement Act of 1994. Because no level of discretionary spending is set by law for the years after 1998, CBO makes two different projections of the deficit for 1999 and later years. In one projection, discretionary spending grows at the rate of inflation;

the purchasing power of the appropriations is thus held constant at the 1998 level. In the other, discretionary spending is frozen at the 1998 dollar level.

In the baseline projections with discretionary spending adjusted for inflation after 1998, the deficit resumes its upward path after the pause in 1998. By 2000, the last year of CBO's regular projections, the deficit of $284 billion is almost back to the record level of 1992 (although at 3.1 percent, it is well below the 1992 deficit as a percentage of GDP). CBO's extended projections show deficits that continue to climb after 2000, reaching $421 billion (3.6 percent of GDP) in 2005. The mounting deficits continue to be fueled primarily by increases in Medicaid and Medicare, even though projected costs for those programs are somewhat lower than CBO had estimated last August. All spending other than that for Medicaid and Medicare is projected to grow at an average rate of about 5 percent a year between 1998 and 2005, slightly slower than the rise in revenues. Projected spending for the two big federal health programs, however, increases at an average rate of almost 10 percent a year after 1998.

In the baseline projections without inflation adjustments for discretionary spending after 1998, deficits level off at around $240 billion a year from 1999 through 2005. (The projected deficit of $242 billion for 2005 is equal to 2.1 percent of GDP.) Freezing discretionary appropriations at the 1998 dollar level through 2005 would result in funding for discretionary programs in 2005 that had about 27 percent less purchasing power than the 1995 appropriations. If total discretionary spending was frozen at the nominal 1998 level but defense spending was preserved at the 1995 funding level adjusted for inflation, the money available for all other discretionary programs in 2005 would have less than half the purchasing power of the 1995 appropriations for those programs.

All mandatory spending is the same in both baselines, except that interest payments reflect the lower deficits and debt in the version that does not adjust discretionary spending for inflation after 1998.

Changes in the Projections

The deficits that CBO currently projects for 1995 through 1999 are almost $25 billion a year higher, on average, than those projected last August (see Table 4). Yet despite those increases, there has been no fundamental change in the deficit outlook. In fact, by 2003, the deficits in CBO's current extended projections are slightly lower than the deficits CBO projected in August.

Legislation enacted since then has had very little effect on the deficit outlook. The two most significant laws were an act making major changes in the federal crop insurance program in hopes of avoiding future ad hoc disaster assistance to farmers and an act implementing the Uruguay Round of the General Agreement on Tariffs and Trade (GATT). The crop insurance legislation increased estimates of the deficit by almost $1 billion a year. Because CBO's baseline projections were made on the basis of current law, they did not include any spending that might result from the enactment of future ad hoc disaster bills. Therefore, reducing the likelihood of such legislation did not produce savings that could offset the higher spending for crop insurance. The GATT implementing legislation added almost $3 billion to deficits over the 1995–1999 period because losses in revenues from lower tariffs were not completely offset by other revenue increases and spending cuts.

Changes in the economic forecast since August have had a greater effect on deficit projections than did legislation. Economic changes have pushed down projected revenues by $9 billion in 1996 and $8 billion in 1997, largely because of lower wage and salary income than had been forecast in August. More significantly, the higher interest rates in the new forecast have driven up projected federal interest payments by more than $15 billion a year, on average, in 1996 through 1999.

Taken altogether, technical reestimates—those changes that cannot be attributed to legislation or revisions in the economic forecast—have had little impact on projections of the deficit. But looking only at the total effect masks some significant changes. Projected Medicaid spending is lower in every year—by as much as $13 billion in 1999—than was estimated in August, reflecting actual 1994 outlays that were lower than expected and evidence that the rapid growth in that program has slowed. Medicare expenditures are down only slightly over the 1995–1999 period, but CBO's extended forecasts have significantly lower spending for Medicare as well as Medicaid in the years after 2000. The Medicaid reductions in 1995 through 2000, however, are more than offset by technical reestimates that bring down projected revenues to reflect smaller-than-anticipated tax collections in 1994 and increased spending for a variety of programs other than Medicare and Medicaid.

THE BUDGET OUTLOOK DIFFERS FROM THE OUTLOOK IN 1980 AND 1981

At the request of Chairman Packwood, CBO has also examined how the current outlook compares with the economic forecast and budget projections CBO made before the Economic Recovery Tax Act of 1981 was enacted. The many changes in budget policy and presentation made since 1981 limit our ability to provide a detailed analysis of the differences between projections that are so widely separated in time. Nevertheless, we can explain the primary reasons for the fundamental differences between the outlook now and the outlook then.

Unlike the current *Economic and Budget Outlook*, CBO's budget reports issued before enactment of the 1981 tax cuts routinely projected that a continuation of current tax and spending laws would lead to large budget surpluses. CBO also warned that such levels of taxes and spending would act as a drag on the economy.

The primary reason for those projections was that high inflation was expected to drive up revenues dramatically. Because key features of the federal individual income tax were not automatically adjusted for inflation, periods of high inflation—such as the late 1970s and early 1980s—pushed individuals into higher tax rate brackets and caused revenues to increase rapidly. In response, policymakers cut taxes every few years on an ad hoc basis—five times in the 1970s, for instance.

Illustrating this dilemma, in its February 1980 report *Five-Year Budget Projections: Fiscal Years 1981–1985*, CBO projected that revenues collected under current tax law would climb from about 21 percent of GNP in 1981 to 24 percent by 1985. Simple arithmetic pointed to enormous surpluses in the out-years. For example, current-law revenues exceeded outlays by a projected $98 billion for 1984 and $178 billion for 1985. Similarly, in its July 1981 report *Baseline Budget Projections: Fiscal Years 1982–1986*, CBO projected budget surpluses of between $148 billion and $209 billion for 1986, depending on the economic assumptions used.

In the same report, CBO estimated that the 1981 tax cuts and other policies that were called for in the May 1981 budget resolution would generate a balanced budget or a small deficit (roughly $50 billion) by 1984—again, depending on the economic assumptions employed.

That budget background led to the 1981 tax cuts. Given the best information available at that time, the Congress and the Administration reasonably thought that significant budget surpluses loomed under current law. Analysts differed, however, on whether the 1981 tax cuts would put the government on a balanced-budget footing or would lead to small budget deficits.

As it turned out, the federal government ran budget deficits of about $200 billion a year from 1983 through 1986. Economic performance was poorer than envisioned in projections of either CBO or the Administration at the time of the 1981 tax bill. The economy plunged into recession, registered negative growth in 1982, and then recovered. The rate of inflation dropped sharply. By 1986, nominal gross national product was about $700 billion smaller than assumed in 1981, which caused a corresponding drop in tax revenues. Furthermore, interest rates remained high despite the plunge in inflation. It is reasonable, then, to ascribe nearly all of the underestimate of deficits during that period to errors in economic forecasts.

ILLUSTRATIVE PATH TO A BALANCED BUDGET

A constitutional amendment requiring a balanced federal budget will be considered during the early days of the 104th Congress. If the Congress adopts such an amendment this year and three-quarters of the state legislatures ratify it over the next few years, the requirement could apply to the budget for fiscal year 2002. If the budget is to be balanced by 2002, it is important that the Congress and the President begin immediately to put into effect policies that will achieve that goal. According to CBO's latest projections of a baseline that adjusts discretionary spending for inflation after 1998, some combination of spending cuts and tax increases totaling $322 billion in 2002 would be needed to eliminate the deficit in that year. The amounts of deficit reduction called for in the years preceding 2002 depend on both the exact policies adopted and when the process is begun.

For illustrative purposes, CBO has laid out one of many possible paths to a balanced budget in 2002 (see Table 5). Starting from a baseline that assumes that discretionary spending is adjusted for inflation after 1998, that path first shows the savings that would be achieved by freezing discretionary spending through 2002 at the dollar level of the 1998 cap. Such a freeze, along with the resulting debt-service effects, would produce $89 billion of the required savings of $322 billion in 2002. Under the freeze policy, the buying power of total discretionary appropriations in 2002 would be approximately 20 percent less than in 1995.

CBO also built into its illustrative path a possible course of savings from further policy changes. The amounts of those savings are not based on the adoption of any particular set of policies; they do assume, however, that policy changes are phased in between 1996 and 1999 in a pattern that is similar to the changes in mandatory spending enacted in the last two major efforts at deficit reduction in 1990 and 1993.

After 1999, the assumed savings increase at the baseline rate of growth for entitlement and other mandatory spending, excluding Social Security—implying that the cuts implemented in earlier years have a permanent effect but no additional policy changes have been made. If those savings were achieved entirely out of entitlement and other mandatory programs (excluding Social Security), they would represent about a 20 percent reduction from current-policy levels for those programs.

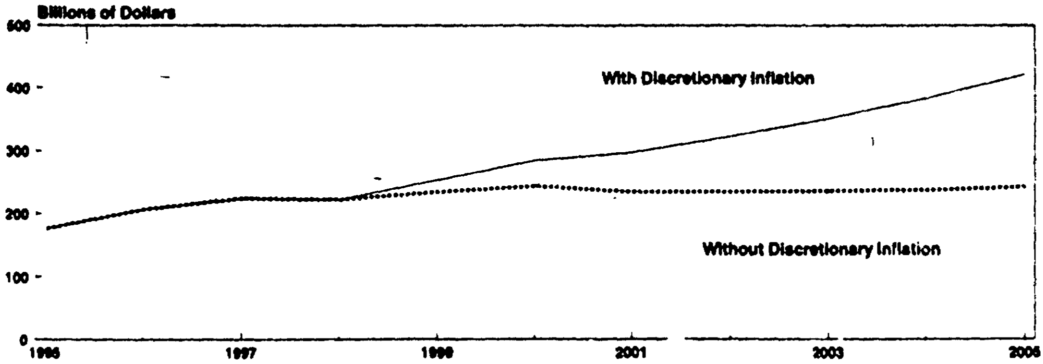
Over the entire 1996–2002 period, the savings in CBO's illustrative path that result directly from policy changes total more than $1 trillion (in relation to a baseline that adjusts discretionary spending for inflation after 1998). When the resulting savings in debt-service payments are included, the total exceeds $1.2 trillion. As noted, this path and the resulting $1.2 trillon in savings are illustrative only; the actual amount of cumulative deficit reduction over the 1996–2002 period will depend on the timing and exact nature of the policies enacted to achieve balance in 2002.

The required savings from policy changes would be smaller and the debt-service savings greater if, as CBO anticipates, ongoing deficit reduction efforts over this period result in lower interest rates. CBO believes that by 2000, interest rates could be as much as 1 percentage point lower than it currently forecasts if spending cuts and tax increases that would lead to a balanced budget have been enacted and the financial markets are convinced that policymakers will maintain those policies. CBO estimates that such a drop in interest rates would lower projected federal interest payments—and the amount of savings from policy changes needed to balance the budget—by almost $140 billion over the 1996–2002 period.

CONCLUSION

CBO's most recent economic and budget projections underscore the challenge facing policymakers who may have to enact the spending cuts or tax increases needed to balance the budget by 2002. Although the long-term budget outlook is no worse now than it was last August, the new projections emphasize that the deficit can be eliminated only through major changes in current policies.

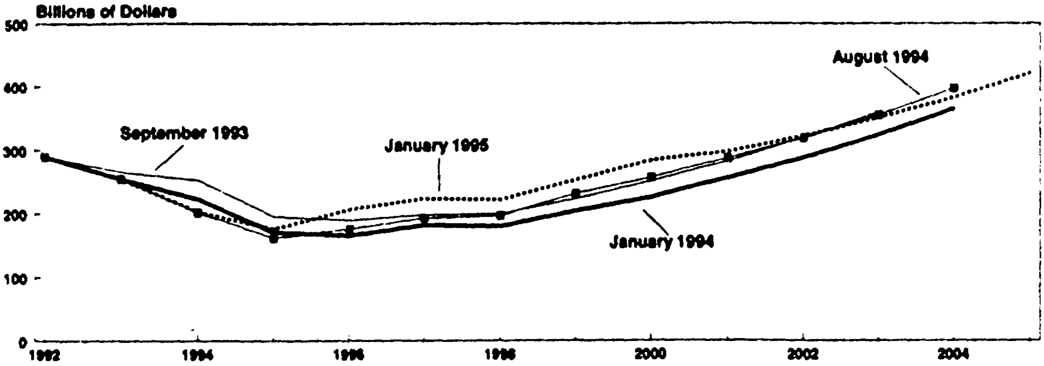
Figure 1.
Comparison of CBO Projections With and Without Discretionary Inflation After 1998 (By fiscal year)



SOURCE: Congressional Budget Office

NOTE: Caps on discretionary spending are set by law through 1998. Measures of the deficit "with discretionary inflation" assume that discretionary spending grows at the rate of inflation after 1998. Measures of the deficit "without discretionary inflation" assume that discretionary spending remains frozen in dollar terms at the level of the 1998 caps.

Figure 2.
Comparison of CBO Deficit Projections (By fiscal year)



SOURCE: Congressional Budget Office.

NOTE: The projections assume that discretionary spending rises with inflation after the caps expire in 1998.

Table 1.
Comparison of Forecasts for 1995 and 1996

	Actual 1993	Estimated 1994	Forecast 1995	Forecast 1996
		Fourth Quarter to Fourth Quarter (Percentage change)		
Nominal GDP				
CBO	5.0	6.3	5.3	4.7
Blue Chip	5.0	6.5	5.7	5.4
Real GDP[a]				
CBO	3.1	3.7	2.5	1.9
Blue Chip	3.1	3.8	2.5	2.2
Implicit GDP Deflator				
CBO	1.8	2.5	2.8	2.8
Blue Chip	1.8	2.6	3.1	3.2
Consumer Price Index[b]				
CBO	2.7	2.8	3.2	3.4
Blue Chip	2.7	2.8	3.5	3.5
		Calendar Year Averages (Percent)		
Civilian Unemployment Rate				
CBO	6.8	6.1	5.5	5.7
Blue Chip	6.8	6.1	5.6	5.7
Three-Month Treasury Bill Rate				
CBO	3.0	4.2	6.2	5.7
Blue Chip	3.0	4.2	6.2	6.1
Ten-Year Treasury Note Rate				
CBO	5.9	7.1	7.7	7.0
Blue Chip[c]	5.9	7.1	7.9	7.6

SOURCES Congressional Budget Office; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (January 10, 1995); Department of Commerce, Bureau of Economic Analysis.

NOTE The *Blue Chip* forecasts are based on a survey of 50 private forecasters.

a Based on constant 1987 dollars.

b The consumer price index for all urban consumers (CPI-U).

c *Blue Chip* does not project a 10-year note rate. The values shown here for the 10-year note rate are based on the *Blue Chip* projections of the Aaa bond rate, adjusted by CBO to reflect the estimated spread between Aaa bonds and 10-year Treasury notes.

Table 2.
The Economic Forecast and Projections (By calendar year)

	Estimated 1994	Forecast 1995	Forecast 1996	Projected 1997	Projected 1998	Projected 1999	Projected 2000
Nominal GDP (Billions of dollars)	6,735	7,127	7,456	7,847	8,256	8,680	9,128
Real GDP (Billions of 1987 dollars)	5,338	5,505	5,602	5,736	5,870	6,004	6,141
Real GDP (Percentage change)	4.0	3.1	1.8	2.4	2.3	2.3	2.3
Implicit GDP Deflator (Percentage change)	2.1	2.6	2.8	2.8	2.8	2.8	2.8
CPI-U (Percentage change)[a]	2.6	3.1	3.4	3.4	3.4	3.4	3.4
Unemployment Rate (Percent)	6.1	5.5	5.7	5.8	5.9	6.0	6.0
Three-Month Treasury Bill Rate (Percent)	4.2	6.2	5.7	5.3	5.1	5.1	5.1
Ten-Year Treasury Note Rate (Percent)	7.1	7.7	7.0	6.7	6.7	6.7	6.7

SOURCE: Congressional Budget Office.

a. CPI-U is the consumer price index for all urban consumers.

Table 3.
CBO Deficit Projections (By fiscal year)

	1994	1995	1996	1997	1998	1999	2000
			In Billions of Dollars				
Baseline Total Deficit							
With discretionary inflation after 1998	203	176	207	224	222	253	284
Without discretionary inflation after 1998	203	176	207	224	222	234	243
Standardized-Employment Deficit[a]							
With discretionary inflation after 1998	187	200	216	223	221	247	273
Without discretionary inflation after 1998	187	200	216	223	221	228	233
			As a Percentage of GDP				
Baseline Total Deficit							
With discretionary inflation after 1998	3.1	2.5	2.8	2.9	2.7	3.0	3.1
Without discretionary inflation after 1998	3.1	2.5	2.8	2.9	2.7	2.7	2.7
Standardized-Employment Deficit[b]							
With discretionary inflation after 1998	2.8	2.8	2.9	2.9	2.7	2.9	3.0
Without discretionary inflation after 1998	2.8	2.8	2.9	2.9	2.7	2.6	2.6

SOURCE: Congressional Budget Office.

NOTE: Caps on discretionary spending are set by law through 1998. Measures of the deficit "with discretionary inflation" assume that discretionary spending grows at the rate of inflation after 1998. Measures of the deficit "without discretionary inflation" assume that discretionary spending remains frozen in dollar terms at the level of the 1998 caps.

a. Excludes the cyclical deficit and spending for deposit insurance.

b. Shown as a percentage of potential gross domestic product.

Table 4.
Changes in CBO Deficit Projections (By fiscal year, in billions of dollars)

	1995	1996	1997	1998	1999
August 1994 Baseline Total Deficit with Discretionary Inflation After 1998	162	176	193	197	231
Changes					
Policy changes	2	2	2	3	3
Economic assumptions					
Revenues[a]	2	9	8	3	b
Net interest	8	16	17	15	15
Other outlays	b	b	1	2	2
Subtotal	10	25	27	20	17
Technical reestimates					
Revenues[a]	6	5	6	9	11
Deposit insurance[c]	1	3	b	b	1
Medicaid and Medicare	-7	-6	-8	-11	-15
Net interest[c]	b	-1	b	b	1
Other outlays	b	5	4	3	5
Subtotal	1	5	2	2	2
Total	13	31	31	26	22
January 1995 Baseline Total Deficit with Discretionary Inflation After 1998	176	207	224	222	253

SOURCE: Congressional Budget Office.

NOTE: Caps on discretionary spending are set by law through 1998. Measures of the deficit "with discretionary inflation" assume that discretionary spending grows at the rate of inflation after 1998.

a. Revenue reductions are shown with a positive sign because they increase the deficit.

b. Less than $500 million.

c. Excludes changes in interest paid by deposit insurance agencies to the Treasury. These interest payments are intrabudgetary and do not affect the deficit.

Table 5.
Illustrative Deficit Reduction Path (By fiscal year, in billions of dollars)

	1995	1996	1997	1998	1999	2000	2001	2002	1996-2002
CBO January Baseline Deficit with Discretionary Inflation After 1998	176	207	224	222	253	284	297	322	n.a.
Freeze Discretionary Outlays After 1998									
Discretionary reduction	0	0	0	0	-19	-38	-58	-78	-193
Debt service	0	0	0	0	-1	-2	-6	-10	-19
Total Deficit Reduction	0	0	0	0	-19	-40	-63	-89	-212
CBO January Baseline Deficit Without Discretionary Inflation After 1998	176	207	224	222	234	243	234	234	n.a.
Additional Deficit Reduction									
Policy changes[a]	0	-32	-65	-97	-145	-156	-168	-180	-843
Debt service	0	-1	-4	-10	-18	-28	-40	-54	-156
Total Deficit Reduction	0	-33	-69	-106	-163	-184	-208	-234	-998
Resulting Deficit	176	174	155	116	71	59	26	b	n.a.
Total Change from Baseline Deficit with Discretionary Inflation After 1998									
Policy changes	0	-32	-65	-97	-164	-194	-225	-259	-1,035
Debt service	0	-1	-4	-10	-19	-31	-46	-64	-175
Total Deficit Reduction	0	-33	-69	-106	-182	-225	-271	-322	-1,210

SOURCE: Congressional Budget Office.

NOTES: Caps on discretionary spending are set by law through 1998. Measures of the deficit "with discretionary inflation" assume that discretionary spending grows at the rate of inflation after 1998. Measures of the deficit "without discretionary inflation" assume that discretionary spending remains frozen in dollar terms at the level of the 1998 caps.

n.a. = not applicable.

a These changes represent only one of a large number of possible paths that would lead to a balanced budget. The exact path depends on when deficit reduction begins and the specific policies adopted by the Congress and the President. The path illustrated in this table is not based on any specific policy assumptions but does assume that policies are fully phased in by 1999.

b Surplus of less than $500 million.

CONGRESSIONAL BUDGET OFFICE
U.S. Congress
Washington, DC 20515

Robert D. Reischauer
Director

November 8, 1994

The Honorable Bob Packwood
United States Senate
Washington, DC 20510

Dear Senator:

This is in response to your request of November 3, asking CBO to provide additional information about budget projections done almost 15 years ago, before enactment of the Economic Recovery Tax Act (ERTA) of 1981. As you recognize, many changes in budget policy and presentation hamper our ability to answer questions about projections that are so widely separated in time. Nevertheless, we will answer the questions posed in your letter as best we can.

Briefly, before the enactment of ERTA, CBO's budget reports routinely warned that a continuation of current tax and spending laws would lead to a surplus that would act as a drag on the economy. The late 1970s and early 1980s were a period of high inflation. Key features of the individual income tax--brackets, personal exemptions, and standard deductions--were not indexed for inflation, even though inflation tended to push taxpayers into progressively higher tax brackets. In response, policymakers typically enacted ad hoc tax reductions every few years to keep the revenue-to-GDP ratio from spiraling. Examples are the tax cuts enacted in 1964, 1969, 1971, 1975, 1976, 1977, and 1978. On the spending side of the budget, many entitlement programs (such as Social Security) were automatically indexed to inflation, but discretionary programs had no such automatic feature and relied on the annual appropriation process for funding (if any) to compensate them for inflation.

In doing its pre-ERTA projections, then, CBO faced a dilemma: literal projections of current-law revenues and spending implied a fiscal drag that was viewed as incompatible with long-term growth. Therefore, CBO's economic projections assumed changes in fiscal policy sufficient to offset this effect and were not predicated on unchanged laws. The tax cuts enacted in 1981 and subsequent economic developments, of course, erased projected surpluses from CBO's reports.

CBO February 1980 Projections

Illustrating this dilemma, in its February 1980 report *Five-Year Budget Projections: Fiscal Years 1981-1985*, CBO projected that the revenues collected under current tax law would climb from about 21 percent of GNP in 1981 to 24 percent by 1985. Simple arithmetic pointed to enormous surpluses in the outyears. For example, current-law revenues exceeded outlays by a projected $98 billion for 1984 and $178 billion for 1985.

CBO purposely did not, however, publish these surpluses, which it called the "budget margin." The reason was one of internal consistency. CBO's assumptions of economic performance beyond the two-year forecasting horizon were based on an analysis of historical trends and the economy's long-run growth potential. Thus, the February 1980 report assumed that the economy would grow at a real rate of 3.8 percent a year in 1982 through 1985. Such growth was incompatible with a rising revenue-to-GDP ratio; in fact, the report stated that "fiscal policy changes that would use up most of the budget margin would be required if the economic growth path were to be achieved." The economic assumptions assumed approximate budget balance in 1983 through 1985 but did not assume specific tax cuts or changes in spending.

Early 1981 Projections

The tax environment changed in 1981. By mid-1981, the Congress and the Administration had agreed on a large multi-year tax cut. The budget resolution prescribing the approximate size of the cuts was adopted in May, and ERTA itself was enacted in August. Indexing for inflation was not a feature of the Administration's tax proposals submitted in March 1981, but was a part of ERTA. It did not take effect until 1985, after an intervening series of three cuts in individual income taxes effective at the start of calendar years 1982, 1983, and 1984.

Economic assumptions. CBO presented its baseline projections in 1981 using two different sets of economic assumptions--those contained in the budget resolution (resembling the Reagan Administration's assumptions), and an alternative set developed independently by CBO. For the reasons described above, economic forecasts require an assumption about fiscal policy; the CBO assumptions explicitly assumed adoption of a package of tax cuts and spending cuts like those advocated by the Administration.

Budget projections. Without the tax cuts, long-run surpluses still appeared likely from the vantage point of early 1981. For example, using the economic assumptions dictated by the budget resolution, CBO envisioned a surplus of $76 billion in 1984 and $209 billion in 1986 if no changes in tax law or spending policy were adopted (*Baseline Budget Projections: Fiscal Years 1982-1986*, July 1981). Those economic assumptions were rosier than the set developed independently by CBO. Budget projections based on CBO's economic assumptions, which were more fully documented in a March 1981 report (*An Analysis of President Reagan's Budget Revisions*), foresaw smaller surpluses amounting to $23 billion in 1984 and $148 billion in 1986.

The budget resolution was expected to generate a bare $1 billion surplus in 1984, under the economic assumptions contained therein. That would presumably imply a deficit of roughly $50 billion under CBO's less rosy assumptions.

In sum, given the best information available at the time, the Congress and the Administration reasonably thought that surpluses loomed under current law. Analysts differed, however, on whether following the policies of the first budget resolution would put the government on a balanced-budget footing or would lead to deficits.

Post-1981 Deterioration

Economic developments led to far bigger deficits than even relatively pessimistic participants in the 1981 debate envisioned. As you requested, we have prepared a comparison of the economic assumptions contained in the fiscal year 1982 budget resolution with the actual outcomes (see attached Table 1). For completeness, we also include a comparison with the CBO alternative forecast published in March 1981. Revisions by the Department of Commerce to economic data (such as the shift in the base year for measuring real growth) prevent the actuals from being perfectly comparable to the projections, but do not distort the overall story.

Compared with the budget resolution, the most dramatic deviations in economic performance were sharply lower real growth and sharply lower inflation. The economy plunged into recession, registered negative growth in 1982, and then recovered. Even so, real growth over the 1981-1986 period (including recession and recovery years) averaged 2.6 percent, versus the budget resolution's assumption of 4 percent. Inflation was sharply lower than in the budget resolution, averaging 4.9 percent over the 1981-1986 period (when measured by the CPI) versus the 6.6 percent assumed in the resolution. These two factors--lower real growth and lower inflation--caused nominal GNP to be about $700 billion smaller by 1986 than assumed in the resolution, with a corresponding drop in the tax base. Interest rates, however, did not behave very differently than assumed in the resolution--implying that real interest rates (nominal rates adjusted for inflation) were much higher than foreseen.

In one crucial respect, the economy performed closer to CBO's early-1981 alternative forecast. Although CBO did not foresee the recession, it did envision average real growth of 2.8 percent over the 1981-1986 period, compared with an actual rate of 2.6 percent. CBO overestimated inflation, and underestimated real interest rates (as proxied by nominal Treasury bill rates minus inflation).

The post-1981 deterioration in the budget picture cannot be allocated to individual economic variables--real growth, inflation, and interest rates--as you requested. But it is clear that economic factors were mostly responsible, with so-called technical factors running a distant second. In 1986, the deficit was more than $400 billion greater than in the CBO July 1981 baseline projections (see attached Table 2). Policy changes contributed slightly over $100 billion; this figure includes not just the impact of ERTA and other changes adopted in 1981 but also the effects of later changes, such as the Tax Equity and Fiscal Responsibility Act and the 1983 Social Security Amendments, enacted to curb the burgeoning deficit. Economic and technical changes contributed the remaining $300 billion. The deterioration was overwhelmingly in the areas of revenues and net interest and it is reasonable to ascribe nearly all of it to errors in the economic forecast.

Of course, the indexation of the tax system contributed very little to the deterioration in this five-year period, because indexing did not take effect until 1985. By then, CBO estimated that repealing it would generate a mere $5 billion in fiscal year 1985 and less than $15 billion in 1986. Since 1985, indexation--the annual adjustments to tax brackets and other features of the individual income tax code--has operated, other things being equal, to keep such taxes roughly constant as a share of GDP.

I hope that this information is helpful to you. If you have additional questions, please do not hesitate to contact me. The principal CBO staff contact is Kathy Ruffing (X62880); more detailed questions about revenues can be answered by Rosemary Marcuss (X62680) and inquiries about CBO's economic forecast by Robert Dennis (X62750).

Sincerely,

Robert D. Reischauer
Director

Attachments

TABLE 1. ECONOMIC ASSUMPTIONS IN THE FIRST BUDGET RESOLUTION FOR FISCAL YEAR 1982 AND ACTUAL OUTCOMES (By calendar year)

08-Nov-94	1980	1981	1982	1983	1984	1985	1986
			First Budget Resolution for 1982 a/				
Nominal GNP (dollars)	2,626	2,941	3,323	3,734	4,135	4,541	4,963
Real GNP growth (percentage change)	-0.2	2.0	4.1	5.0	4.5	4.2	4.2
Consumer price index (percentage change)	13.5	11.0	8.3	6.2	5.5	4.7	4.2
Unemployment rate	7.1	7.5	7.2	6.6	6.4	5.9	5.6
3-month Treasury bill rate	11.4	13.5	10.5	9.4	8.2	7.0	6.0
			CBO Alternative Assumptions of March 1981 b/				
Nominal GNP (dollars) c/	2,626	2,936	3,285	3,663	4,081	4,558	5,055
Real GNP growth (percentage change)	-0.2	1.3	2.5	2.7	3.0	3.8	3.7
Consumer price index (percentage change)	13.5	11.3	9.5	8.9	8.2	7.7	7.1
Unemployment rate	7.1	7.8	7.9	7.8	7.7	7.5	7.2
3-month Treasury bill rate	11.4	12.6	13.7	11.5	10.2	9.7	9.3
			Actual d/				
Nominal GDP (dollars)	2,708	3,031	3,150	3,405	3,777	4,039	4,269
Real GDP growth (percentage change)	-0.5	1.8	-2.2	3.9	6.2	3.2	2.9
Consumer price index (percentage change)	13.5	10.3	6.2	3.2	4.3	3.6	1.9
Unemployment rate	7.1	7.6	9.7	9.6	7.5	7.2	7.0
3-month Treasury bill rate	11.4	14.0	10.6	8.6	9.5	7.5	6.0

a The budget resolution contained assumptions through 1984; assumptions for 1985 and 1986 are a CBO extrapolation They were published in Baseline Budget Projections: Fiscal Years 1982-1986 (July 1981).

b CBO's alternative assumptions assumed fiscal policy changes comparable to those contained in President Reagan's March 1981 budget revisions. These alternative projections were published in An Analysis of President Reagan's Budget Revisions for Fiscal Year 1982 (March 1981) and in Baseline Budget Projections: Fiscal Years 1982-1986 (July 1981)

c Nominal GNP was not published; these levels are estimated using the published growth rates.

d The actuals are not strictly comparable to the 1981 projections. They reflect the shift in emphasis from GNP to GDP and the redefinition of the base year used in measuring real economic growth (from 1972 at the time of the 1981 projections to 1987 for the most recent actuals). These changes, however, do not seriously distort the comparison.

TABLE 2. CHANGES IN BUDGET OUTLOOK, 1982-1986, FROM CBO JULY 1981 BASELINE

08-Nov-94	1982	1983	1984	1985	1986
			CBO July 1981 Baseline a/		
Revenues	709	810	920	1033	1159
Outlays					
Net interest	72	70	67	62	59
Other b/	687	742	796	853	911
Total	759	812	863	915	970
Deficit or surplus (-)	50	2	-56	-118	-189
			Changes		
Policy Changes					
Revenues	-43	-75	-100	-117	-133
Outlays					
Net interest	0	1	6	16	29
Other a/ c/	-40	-39	-36	-15	-51
Total	-40	-38	-30	1	-23
Deficit	3	37	70	118	110
Economic and Technical Changes					
Revenues	-48	-135	-153	-182	-257
Outlays					
Net interest	13	19	38	51	48
Other a/	14	16	-20	-21	-5
Total	26	35	19	30	43
Deficit	75	169	171	212	300
Total Changes					
Revenues	-91	-210	-253	-299	-390
Outlays					
Net interest	13	20	44	67	77
Other a/	-26	-24	-56	-36	-57
Total	-13	-4	-11	32	20
Deficit	78	206	242	331	410
			Actual Outcomes		
Revenues	618	601	666	734	769
Outlays					
Net interest	85	90	111	130	136
Other a/	661	719	741	817	854
Total	746	808	852	946	990
Deficit	128	208	185	212	221

SOURCE: CBO memorandum, "Changes in Budgetary Policies Since January 1981" (May 30, 1986), updated for fiscal year 1986 actuals.

a. The July 1981 baseline was based on the economic assumptions of the first concurrent resolution, not those of CBO.
b. Adjusted by approximately $20 billion a year in formerly off-budget outlays (chiefly lending by the Federal Financing Bank).
c. Includes a one-time cost of about $12 billion for the purchase of maturing subsidized housing notes in fiscal year 1985.

CONGRESSIONAL BUDGET OFFICE
U.S. Congress
Washington, DC 20515

Robert D. Reischauer
Director

December 15, 1994

Honorable Bob Packwood
United States Senate
Washington, DC 20510

Dear Senator:

This responds to your request for additional information about budget projections done before the 1981 tax cuts were enacted. The conclusions that follow were discussed more extensively in my letter to you of November 8, 1994.

Before enactment of the 1981 tax cuts, CBO's budget reports routinely projected that a continuation of current tax and spending laws would lead to large budget surpluses. CBO also warned that such levels of taxes and spending would act as a drag on the economy.

The primary reason for this outlook was that high inflation was expected to drive up revenues dramatically. Because key features of the federal individual income tax were not automatically adjusted for inflation, periods of high inflation--like the late 1970s and early 1980s--pushed individuals into higher tax rate brackets and caused revenues to increase rapidly. In response, policymakers cut taxes every few years on an *ad hoc* basis--five times in the 1970s alone.

Illustrating this dilemma, in its February 1980 report *Five-Year Budget Projections: Fiscal Years 1981-1985*, CBO projected that revenues collected under current tax law would climb from about 21 percent of GNP in 1981 to 24 percent by 1985. Simple arithmetic pointed to enormous surpluses in the outyears. For example, current-law revenues exceeded outlays by a projected $98 billion for 1984 and $178 billion for 1985. Similarly, in its July 1981 report *Baseline Budget Projections: Fiscal Years 1982-1986*, CBO projected budget surpluses of between $148 billion and $209 billion for 1986, depending on the economic assumptions used.

In the same report, CBO estimated that the 1981 tax cuts and other policies that were called for in the May 1981 budget resolution would generate a balanced budget or a small deficit (roughly $50 billion) by 1984--again, depending on the economic assumptions employed.

This was the budget background leading to the 1981 tax cuts. Given the best information available at that time, the Congress and the Administration reasonably thought that significant budget surpluses loomed under current law. Analysts differed, however, on whether the 1981 tax cuts would put the government on a balanced-budget footing or would lead to small budget deficits.

As it turned out, the federal government ran budget deficits of about $200 billion a year from 1983 through 1986. Economic performance was poorer than envisioned in projections of either CBO or the Administration at the time of the 1981 tax bill. The economy plunged into recession, registered negative growth in 1982, and then recovered. The rate of inflation dropped sharply. By 1986 nominal GNP was about $700 billion smaller than assumed in 1981, which caused a corresponding drop in tax revenues. And interest rates remained high despite the plunge in inflation. It is reasonable to ascribe nearly all of the underestimate of deficits during this period to errors in economic forecasts.

Sincerely,

Robert D. Reischauer
Director

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