MANUFACTURERS ALLIANCE Policy Review

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Toward a Balanced Budget by 2002: Progress and Promise

Introduction

The national elections of November 1992 dramatically changed the political landscape by transferring control of both the House of Representatives and the Senate to the Republicans. A major focus of the new Republican majority has been an intensified effort to reduce, and even eliminate, the federal budget deficit. This focus has produced efforts to pass both the Balanced Budget Amendment to the Constitution and legislation to give the President a modified line-item veto. Although neither of these measures has passed, both will reemerge as significant issues between now and the 1996 national elections. The most dramatic efforts, however, have centered around an attempt to balance the federal budget.

The annual budget process revolves around the federal government's fiscal year, which begins October 1. The law governing the budget process establishes a schedule of events leading up to the passage of a final budget. Although the exact dates are seldom met, the rough schedule is regularly adhered to. The legislative process begins in February when the President submits his budget to the Congress for the fiscal year beginning in the following October. By April 15, the Congress is supposed to pass a budget resolution setting out the broad details of revenue and spending. The resolution does not go the President and does not have the force of law. Instead it serves as general guidance to other committees, especially the appropriations committees. The committees then begin marking up legislation so that it is in place before the fiscal year actually begins. Earlier this year both the House and Senate passed a budget resolution that called for a balanced budget within seven years (HConRes 67).

The main focal points will involve a total of at least 14 bills. Roughly one-third of all government spending occurs in discretionary programs. The funding for these programs must be reapproved each year by the appropriations committees. Total discretionary spending is spread among a total of 13 appropriations bills. The remaining two-thirds of government spending and the raising of almost all revenue occur outside the appropriations process. So-called mandatory spending and taxes can be changed only by rewriting the existing legislation that governs them. The highlight of this year's legislative process will be the drafting of a massive reconciliation bill containing all of the changes in existing legislation, including any tax cuts. Because the Republicans are unlikely to obtain a sufficient number of votes to override a veto, each of these bills

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must be signed by the President in order to become law.

This report examines the progress that has been made on deficit reduction during the past two years and forecasts the result of on-going congressional efforts. It looks at the benefits to be derived from further deficit reduction and outlines the budget resolution's plans to achieve balance. The report also discusses the Administration's likely response to these activities and the political circumstances surrounding the debate.

A History of Deficits

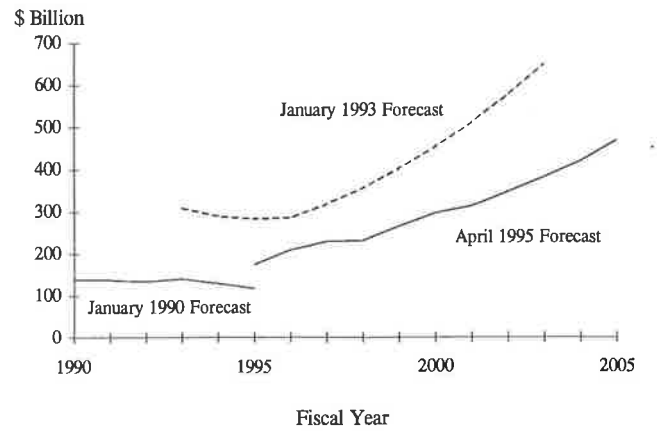
It is possible to blame recent deficits on many causes; the tax cuts and defense increases of the early 1980s, the savings and loan crisis of the mid-80s, and the rapidly increasing costs of entitlement programs, especially Medicare and Medicaid, in the late 1980s and early 1990s. This report does not attempt to sort out the various causes for the large deficits over the past 15 years. Significant tax increases were enacted in 1990 and 1993 and defense expenditures have been reduced substantially since 1985. As a result, the source of the current deficit and the large increase in the deficit projected over the next 10 years is primarily attributable to the forthcoming explosion in the cost of a number of entitlement programs, especially in government health care programs. Achieving balanced budgets will require significant changes in these nondiscretionary programs.

During the last 15 years periodic attempts have been made to reduce, and even eliminate, the deficit. These attempts share common patterns. They occur every two to three years. They almost invariably increase spending during the next year or two to gain political acceptance for tougher cuts promised in later years. As a result, most of the deficit reduction is back-loaded into later years. Finally, actual deficits in the later years tend to be higher than forecast.

There is no question that the budget deficit is lower since the Clinton Administration took office. The Administration proudly points to the fact that the deficit has declined for three years in a row. Recently, it predicted that the deficit for fiscal year (FY) 1995 will be $160 billion, $33 billion lower than it projected just six months ago. The Congressional Budget Office (CBO) is likely to issue a similar finding when it completes its mid-year review of the budget.

The Omnibus Budget Reconciliation Act of 1993 will produce lower deficits than would otherwise have occurred. But most of the deficit reduction that has occurred is the result of improved economic conditions following the most recent recession and slower increases in health care costs. These gains are subject to a rapid reversal if economic conditions worsen. Chart 1 shows several things. First it shows the CBO forecast for future deficits that faced George Bush in early 1990. These deficits caused sufficient concern to cause the President to abandon his "no new taxes" pledge and engage in negotiations with the Democrats in Congress to reduce the deficit (at the time, CBO only published five-year forecasts). Second, it shows that, despite the large deficit reduction package passed in the Fall of 1990, the deficit projections worsened dramatically so that by 1993 CBO was predicting that the deficit would exceed $600 billion within 10 years. Third, it shows that current forecasts are remarkably improved from those of two years ago. But they are still higher than those that caused so much concern during the Bush Administration. The relief from falling deficits should be tempered by the fact that we have still not returned to where we were five years ago.

Chart 1
CBO Forecasts for Deficit Spending



Sources: CBO, *The Economic and Budget Outlook: Fiscal Years 1991-1995; The Economic and Budget Outlook: Fiscal Years 1994-1998; An Analysis of the President's Budgetary Proposals for Fiscal Year 1996.*

Despite the improvement over the last few years the federal deficit is still higher than it was before the most recent recession. Strong forces within mandatory entitlement programs, including an aging population and rising medical costs, cause them to expand steadily over time. Regular deficit reduction is needed just to counteract the effects of these forces. Without an actual reform of the programs that limits their continued upward bias, no plan will keep the deficit steady, let alone eliminate it.

The Need for Deficit Reduction

The Administration's FY 1996 budget did not provide for much deficit reduction over the next five years. In part this was a political maneuver to make the Congress go first in proposing cuts to popular programs and to deny Republicans political cover. In part it was also a victory within the Administration for those who are of the opinion that deficit reduction is not a national priority. Many officials within the Administration believe that it has already accomplished a great deal of deficit reduction, for which it has not been given political credit. They also believe that the national interest requires greater government involvement in areas such as physical infrastructure, education, and worker training.

In justifying its refusal to recommend further deficit reduction, the Administration boasted that the deficit has already been reduced by over half when measured as a percentage of the gross domestic product (GDP). When using this measure, the United States is running lower deficits than most of the other G-7 industrialized countries (Table 1).

Table 1
Deficit as Percentage of GDP for G-7 Countries

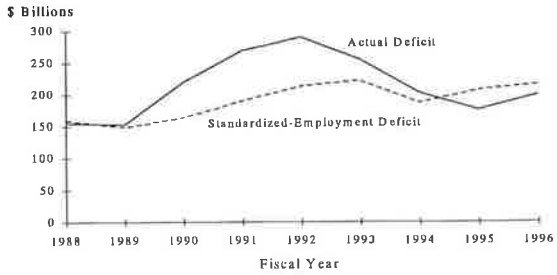
	Percentage	
Country	1995	1996
United States	2.3	2.4
Japan	4.2	4.2
Germany	1.5	1.6
France	3.7	3.0
Italy	7.8	7.2
United Kingdom	3.9	2.4
Canada	2.9	1.9

Source: International Monetary Fund, *World Economic Outlook, May 1995*, p. 142.

These arguments ignore certain realities. The Administration measures deficit reduction from the year it took office to the present and claims credit for all of the progress. Although this is understandable, it is also misleading. As Chart 2 shows, the standardized-employment deficit[1] has fallen by less than half of the amount of the actual deficit. Less than half of the deficit reduction that has occurred is directly due to policy changes enacted as part of the 1993 budget agreement.

[1] The structural or standardized-employment deficit shows what the deficit would be if the economy were performing at its long-term potential. It removes the effect that cyclical economic behavior has on the annual deficit.

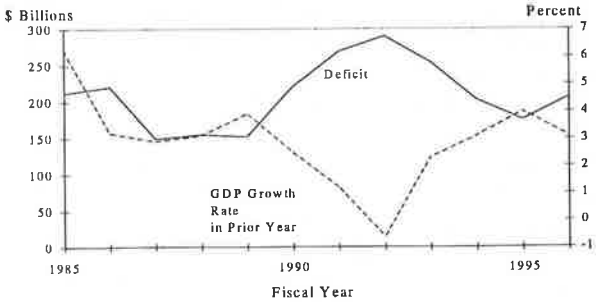
Chart 2
Past and Forecasted Actual-and Standardized-Employment Deficits



Source: CBO, *The Economic and Budget Outlook: Fiscal Years 1996-2000*, pp. xvi, 91-92.

A major reason for roughly half of the decline in the deficit is that the time period used by the Administration happens to coincide perfectly with an economic recovery under the normal business cycle. Chart 3 shows that the actual deficit responds inversely to economic growth. In the chart, economic growth has been lagged one year, since much of its impact on the budget is delayed. The Administration came in at the high-water mark of the recent recession's effect on the budget and is now in the trough. It is thus natural that the deficit has improved markedly.

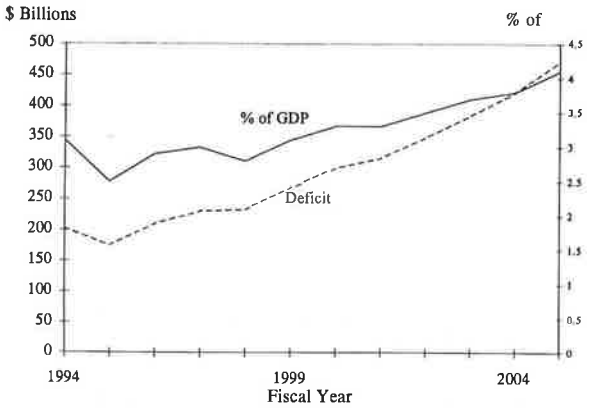
Chart 3
Relationship Between Deficits and Prior Years' Real GDP



Sources: CBO, *An Analysis of the President's Budgetary Proposals for Fiscal Year 1996;* Council on Economic Advisors, *The Economic Report of the President 1995.*

The Administration's argument that the deficit is relatively low when measured as a percentage of GDP also ignores the forecast for future deficits. As Chart 4 (on page 4) shows, recent CBO forecasts foresee this percentage doubling over the next decade unless action is taken. Budget deficits already impose a large burden on the economy and higher deficits will only make it worse.

Chart 4
CBO Forecast for Deficits in Billion $ and as a Percent of GDP



Source: CBO, *An Analysis of the President's Budgetary Proposals for Fiscal Year 1996*, p. 49.

Long-Term Benefits of a Balanced Budget

The point has often been made that the single most important step the federal government could take to increase national savings and reduce the foreign trade deficit is to balance the budget. The benefits of deficit reduction have been estimated by the CBO. CBO believes that a credible plan to balance the federal budget deficit by 2002, the date set by the Budget Resolution, would result in lower interest rates and slightly higher real economic growth. Long-term rates could fall 170 basis points by the end of the seven-year period, while GDP growth would be one-tenth of a point higher than otherwise.[2] Although a tenth of a point does not make a dramatic difference over the short-term, compounded over several years, it has a noticeable impact on living standards.

Beside reducing the deficit by lowering payments on the national debt and increasing revenues, these changes would produce large benefits to the private sector. Lower interest rates would reduce the cost of capital investments for both producers and their customers. Higher growth rates would raise income levels, leading to stronger consumer demand.

The key to the CBO estimates is that deficit reduction must be credible before the financial markets will react favorably. A seven-year deficit reduction plan is less credible than a five-year plan, especially if much of the tough spending reductions are delayed until later years. A 10-year plan, such as that proposed by the Administration, is even less likely to produce an immediate positive response. Given the failure of past deficit reduction efforts, investors are likely to demand tangible progress before they accept lower interest rates and increase their investment.

Although the budget resolution projects balanced budgets, it does not deliver them. Deliverance requires further action by the Congress. Deficit reduction inevitably involves losers. Every federal expenditure benefits someone. Thus there will be fierce fights over the distribution of any spending cuts. Actual deficit reduction depends upon the Congress enacting real cuts in spending.

The Congressional Budget Resolution

The Congressional budget resolution for FY 1996 projects a balanced budget in 2002 by limiting the growth of federal outlays. Chart 5 shows the projected deficits under both current law and the resolution. For comparison purposes, CBO's estimate of the President's latest plan to balance the budget over 10 years also is shown. The resolution assumes large tax cuts, making the required spending cuts even deeper. The following discussion reviews the resolution's treatment of each of the budget's major components.

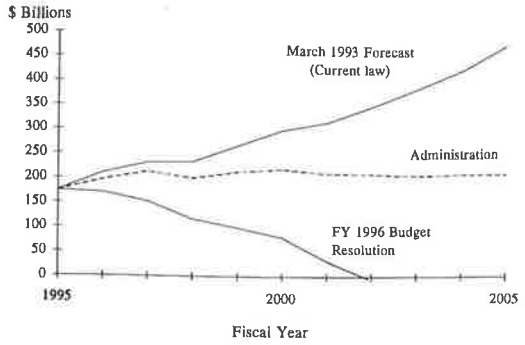
Discretionary spending.—Discretionary spending accounts for roughly one-third of all government outlays. Unlike entitlements, discretionary programs must be separately funded each year. Although authorization bills spell out the structure and purposes of each program, they make spending on the program subject to appropriation. Separate appropriations bills specify exactly how much money may be spent on each program and usually limit the authority to spend the money to one year. Appropriations bills also often attach additional restrictions on how the money may be spent. Unless a new appropriations bill is passed each year, spending for most discretionary programs comes to a halt on October 1, when the government's fiscal year begins and spending authority from the old year lapses.

The Congress has divided discretionary spending into 13 separate appropriations bills. The defense appropriations bill is by far the largest, accounting for roughly half of all discretionary spending. For the first three years of the budget plan, the budget resolution resurrects the practice of placing separate ceilings on defense and nondefense spending. If spending exceeds these caps, an across-the-board reduction would be made in all discretionary programs under the cap in order to make up the difference. After fiscal year 1998, discretionary programs are once again subject to a single combined cap.

Separate caps existed for fiscal years 1991-1993, but were discarded afterward. The effect of

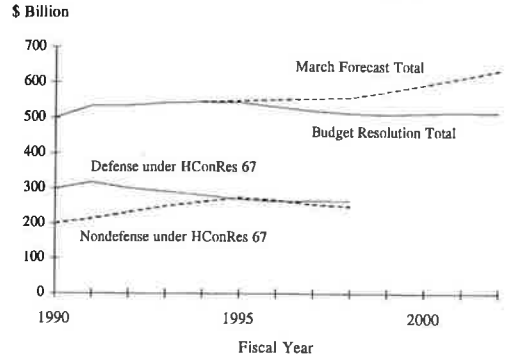
[2] CBO, *An Analysis of the President's Budgetary Proposals for Fiscal Year 1996*, p. 53.

Chart 5
CBO Forecasts of the Deficits Under Alternative Budget Plans



Sources: CBO, *An Analysis of the President's Budgetary Proposals for Fiscal Year 1996*, p. 49; Letter by June E. O'Neil, Director, CBO, to John R. Karich, Chairman, House Budget Committee, June 16, 1995; HConRes 67.

Chart 6
CBO Forecasts for Discretionary Spending



Sources: CBO, *An Analysis of the President's Budgetary Proposals for Fiscal Year 1996*, p. 49; HConRes 67.

separate caps is to protect defense spending from being cut in order to increase spending on domestic programs. Although the Congress is not obliged to spend the full amount allowed by the budget resolution, any defense savings would have to go to deficit reduction and could not be used to increase domestic spending.

Current law already sets caps on total discretionary spending through fiscal year 1998. As Chart 6 shows, total discretionary spending is scheduled to fall by roughly 2 percent annually between 1996 and 1998 and remain steady until then. Except in 1996, when defense programs suffer roughly half of the cuts, all of the decreases are scheduled to come from nondefense programs. In 2002, total discretionary spending is projected to be almost 18 percent lower than it would be under the CBO forecast.

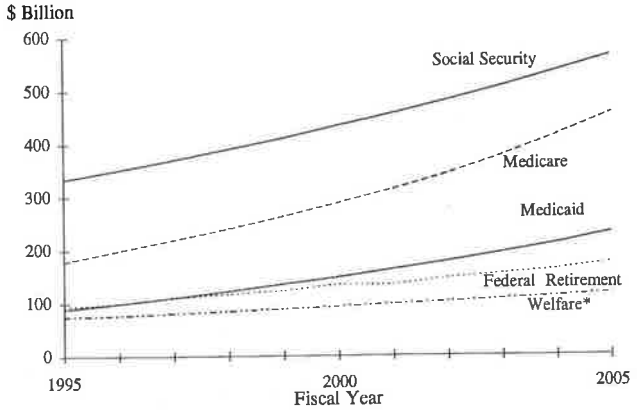
The budget resolution provides the appropriations committees with few guidelines on how to allocate the money under the cuts. Recent debates on funding for the B-2 bomber, the Corporation for Public Broadcasting, and the National Service Corps reveal serious differences of opinion between the Administration and the Congress, the House and Senate, Democrats and Republicans, and even among Republicans.

Another important aspect of the appropriations process is that Congress often uses it to attach conditions on how the Administration may spend the money. Although an appropriations bill gives an agency legal authority to spend money, it may prohibit expenditures for certain purposes. By inserting language prohibiting any part of an appropriation from being used to enforce a certain law or to work on a certain regulation, the appropriations committees can in effect change the authorizing statutes. For example, Republicans may use such language to restrict abortions in military hospitals, prohibit the Department of Labor from enforcing the President's executive order on striker replacement, or force the Occupational Health and Safety to cease work on an ergonomics rule. Although the Administration may disagree with many of these restrictions, its ability to threaten a veto is weakened by the fact that no spending can occur unless some form of appropriations passes.

Mandatory spending.—Unlike discretionary programs, mandatory programs, or entitlements, are not subject to appropriations. This means that spending on them does not depend upon the passage of a separate appropriations bill and that, in most cases, spending is not subject to a firm ceiling. As a result, future outlays are more difficult to predict and spending reductions require changes in the authorizing statutes. The power of inertia favors continued spending. Chart 7 (on page 6) shows expected spending levels for major mandatory programs without changes.

The changes in mandatory programs called for in the budget resolution would require action from almost every congressional committee. Traditionally, the legislation from each committee is collected in one massive reconciliation bill. The most recent examples are the Omnibus Budget Reconciliation Acts of 1990 and 1993. Under this approach either everything gets done or nothing gets done—the latter usually not being a feasible alternative. This fall's reconciliation bill may include such diverse and important items as the middle-class tax cut, welfare reform, incremental health reform, pension reform, the elimination of the Department of Commerce, and the reauthorization of agricultural programs.

Chart 7
CBO Forecasts for Expenditures for Selected Mandatory Programs



* Includes Food Stamps, Supplemental Security Income, Family Support, Child Nutrition, and Earned Income Tax Credit.

Source: CBO, *An Analysis of the President's Budgetary Proposals for Fiscal Year 1996*, p. 45.

Senate rules prevent a filibuster on a reconciliation bill. As a result only a majority is needed to pass it. The bill is, of course, subject to a veto by the President. This automatically makes the Administration a player in the process. However, the President's negotiating power will be limited by the necessity of taking either all or none of the bill.

Republicans are likely to seek to increase this pressure by attaching to the bill legislation that the President wants. Examples could include welfare reform, pension reform, and/or the line-item veto. By vetoing the reconciliation bill, the President could also further the perception that he does not really believe in the importance of deficit reduction.

Among the savings assumed in the budget resolution (all measured over seven years) are:

- Medicare savings of $270 billion by limiting annual growth to 6.4 percent.
- Medicaid savings of $182 billion. The budget resolution assumes that Medicaid will be block granted to the states and that total spending will increase annually by 7.2 percent next year and taper down to 4 percent after 1997.
- Welfare reform savings of $100.5 billion. These savings would come from changes to Aid to Families with Dependent Children, Food Stamps, Supplemental Security Income, and the Earned Income Tax Credit, among other programs.
- Additional auctions of the federal spectrum will bring in $14 billion.
- Agricultural program savings of $13 billion.
- Reforms to student loans will reduce net outlays by $10 billion.
- In addition, the resolution assumes that, by 1998, the Bureau of Labor Statistics will revise the methodology for calculating the consumer price index, lowering its average calculated value by 0.2 percent. This change will reduce outlays by lowering cost-of-living adjustments. It also will increase revenues by limiting the adjustment of income-tax brackets.

Taxes.—The budget resolution also allows for $245 billion in tax cuts spread over the next seven years. This is less than the $354 billion tax cut already passed by the House as part of the *Contract With America*, but more than the $97 billion proposed by the Administration in its original budget. Passage of the tax cut is conditioned on CBO certifying that the reconciliation bill would balance the budget by 2002. As mentioned above, CBO is of the opinion that passage of a credible plan to eliminate the deficit would lower interest rates and increase economic growth. This would further reduce the deficit by an estimated $170 billion. This additional budget reduction would then be used to pay for most of the tax cut.

Tax cuts would significantly increase the difficulty of achieving a balanced budget. Although certain tax reductions are likely to benefit the business community, this benefit would be outweighed by the lost benefits from deficit reduction if the goal of eliminating the deficit is jeopardized. Unfortunately, the Administration's ability to argue against significant tax cuts is severely weakened by the fact that its original budget also proposed a tax cut.

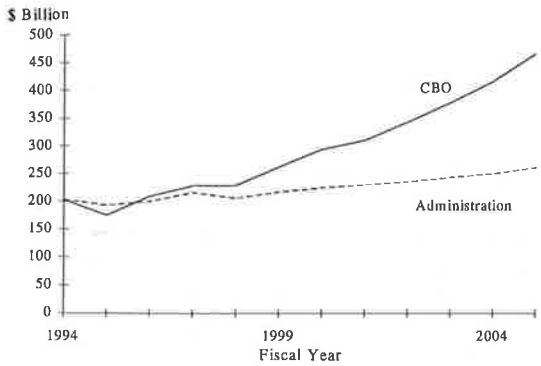
The President's Deficit Reduction Plan

The original strategy of both the Administration and the Democratic party was to let the Republican party go first in advocating a balanced budget. By not proposing further deficit reduction in his original budget, the President forced Republicans to specify the cuts needed to eliminate the deficit. Democrats hoped that by stressing the impact of these cuts on the recipients of federal spending and by criticizing the Republican tax cuts as mainly benefiting higher income persons, they could dampen the public's enthusiasm for deficit reduction and protect most programs.

The President undercut this strategy when he proposed his own plan for eliminating the deficit. The Administration is now on record as supporting the goal of achieving a balanced budget by a date certain. In comparison to the Republican plan, the Administration's blueprint suffers from serious flaws, however. First, it tries to balance the budget

over 10 years instead of seven. Because the main benefits to the private sector from a balanced budget would not appear until markets actually believe that the budget will be balanced, the economic boost under the Clinton plan would be delayed for several years.

Chart 8
Administration and CBO Baseline Estimates of Deficit



Sources: CBO, *An Analysis of the President's Budgetary Proposals for Fiscal Year 1996*, p. 45; OMB.

The economic assumptions used in the President's plan are more optimistic than the CBO assumptions used in the budget resolution. Both sets of assumptions are plausible. As Chart 8 shows, however, the difference amounts to roughly $200 billion in the final years of the plan. As Chart 5 (on page 5) shows, if the CBO estimates are correct, the President's plan would still leave deficits of $200 billion in 2005. Direct comparisons of the Administration and congressional proposals are therefore misleading unless a common set of economic assumptions is used. Chart 5 compares the Administration's new budget plan with both the CBO baseline and the budget resolution.

While it is impossible to say which economic assumptions are correct, the history of deficit reduction exercises makes it wiser to err on the side of greater budget cuts rather than fewer.

Finally, the Administration has not specified which programs it would cut to meet its totals or how it would amend existing programs to achieve the required savings. Documents accompanying the budget resolution offer greater detail about where the budget committees would cut. Although these documents are not binding on other committees, those committees are now going through the process of specifying cuts in the appropriations bills and reconciliation language. The Administration has criticized several of these cuts without always offering alternatives of its own.

Will We Achieve Balanced Budgets by 2002?

The prospect for balanced budgets by 2002 is seriously clouded by the Administration's ability to veto any appropriations or reconciliation bill that the Congress passes. Two events, however, seriously limit the President's veto power and indicate that a dramatic face-off may take place before this issue is decided.

The first event is the end of the government's fiscal year on September 30, 1995. As stated above, spending authority for most discretionary programs, including the authority to spend money on the salaries and administrative expenses needed to run mandatory programs, expires on this date. Unless new appropriations bills are passed by then, large parts of the government will shut down. In the interim, shutdowns can be avoided by the passage of continuing resolutions that provide temporary authority, usually for a few days or weeks, based on last year's spending levels. On the whole, however, the beginning of the new fiscal year on October 1 eventually will force the Administration and the Congress to compromise in order to allow the normal operations of government to continue.

The second event involves the statutory limit on the federal debt held by the public. The federal government generally funds deficits by issuing debt to the public. The total amount of debt currently is limited by statute to $4.9 trillion. Unless this limit is raised before it is reached, the Treasury would have to revert to a cash basis, spending money only as revenues come in. It would be allowed to roll over expiring debt but could not issue new debt to pay for outlays that continue to exceed revenues. Most observers expect the debt limit to be reached around mid-October. The budget resolution anticipates that the statutory limit will be raised to $5.5 trillion in the reconciliation bill, but this rise would only be effective if the reconciliation bill is passed into law. If the bill is vetoed, the existing statutory limit will remain. Thus, although the President can prevent the Congress from passing a reconciliation bill he disapproves of, he cannot borrow the money needed to fund future deficits unless the Congress sends him legislation. Republicans are almost certain to link the two pieces of legislation together, putting more pressure on both parties to compromise.

Even under the budget resolution, the forecast for balanced budgets is doubtful at best. First, although the economic assumptions used by CBO are slightly

more pessimistic than those used by the Administration, they still assume continued steady growth over the next seven years. Added to the 17 straight quarters of economic growth that have already occurred since the last recession, this would make 11 years of uninterrupted economic growth. This would be almost double the length of the average post-war expansion period of the business cycle. It is far more probable that the economy will experience at least one, perhaps two, recessions sometime over the next seven years. Since the last recession caused actual deficits to exceed the standardized-employment deficits by roughly $80 billion, a similar expansion can be predicted in the future. This would set back any deficit reduction efforts.

Second, the focus on tax cuts increases the already difficult job of enacting spending cuts. The difficulty of getting even most Republicans to back strong spending cuts should not be underestimated. By adding to the cuts that must be made and by reducing the focus on deficit reduction, tax cuts jeopardize the economic benefits associated with smaller deficits.

Conclusion and Final Thoughts

Deficit reduction is distinct from, but strongly related to, the reform of government. There is a growing consensus that the major programs that have defined the role of government since the New Deal program of President Roosevelt and the Great Society of President Johnson need fundamental reform. These programs include welfare, farm payments, Medicaid, Medicare, federal retirement plans, and Social Security. In addition, there is a growing consensus that other federal laws not contributing directly to the deficit also need reform. These latter laws and regulations in diverse areas such as pensions, financial regulation, private employment, and the environment affect adversely the performance of the U.S. economy. With regard to both types of legislation, an increasing number of experts argue that they fail to achieve their goals at an acceptable cost and they are often counterproductive. The benefits they produce are often too small to justify the growing burden on either the public or private sectors. As long as the government maintains its current structure of involvement in these areas, the public sector will be unable to accomplish the dramatic improvements in cost and quality that the private sector has recently achieved.

Ideally, changes to government programs should be driven not just by the desire to save money; they should redefine policy goals and also incorporate reforms that improve their ability to achieve these goals. The likelihood of making sensible reforms is reduced by the need for the Congress and the Administration to enact changes by this coming fall.

There is a broad demand among the public for change. Public faith in existing programs is falling and voters are increasingly coming to believe that more than marginal change is needed. Politicians who assert that changes should be made only around the edges challenge this perception. But it is not enough to tear down or eliminate a failed system. Something else must take its place. Sometimes this "something else" can be left to the innovation and resources of the private sector. Even then, however, it is reassuring to have a sound vision for how privatization is likely to work.

There is no clear consensus among the public as to what should replace failed government programs. While the Republican party has led the attack against the old system, it has been less successful at spelling out new approaches to dealing with traditional areas of public concern such as the environment, poverty, and the provision of public goods. Without a clearer idea of what will replace the old system, public resistance to cuts is likely to increase. In the end, the successful accomplishment of deficit reduction may depend on both the elimination of ineffective government programs and the ability of policy officials to develop rational alternatives to current programs that depend less on government and more on private initiative.

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