Issue Brief

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BUDGET DEFICITS:

CAUSES, EFFECTS AND SOME REMEDIAL OPTIONS

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ISSUE DEFINITION

In 1981 Congress enacted extensive changes in taxing and spending policies that supporters of these changes expected to generate sufficient revenues, despite a series of tax rate cuts, to balance the budget by FY84. After the onset of recession in early 1982, however, the Reagan Administration's projections showed widening budget deficits, which culminated in an actual FY83 deficit of $195.4 billion. Despite enactment of the Tax Equity and Fiscal Responsibility Act of 1982, and, more recently, the Deficit Reduction Act of 1984, large deficits are expected to persist, even under continued favorable economic conditions, unless Federal taxing and spending policies are altered dramatically.

How did this unprecedented situation come about? What consequences does it have for the Nation? What remedial actions could be taken? These questions are addressed in this brief.

BACKGROUND AND POLICY ANALYSIS

Earlier Trends and Present Policies

From FY65 to FY81, growth in Federal budget outlays exceeded that of receipts (See Table 1). Defense outlays rose at a compound annual rate of 7.4% during this period, somewhat slower than the 10.8% growth in receipts, while total nondefense spending grew at a 13.0% rate. Outlays for entitlements and other mandatory spending (largely Social Security, Medicare, and unemployment compensation) soared at a 14.8% rate, while growth in net interest payments also exceeded that of receipts. Nondefense discretionary spending (outlays for transportation, agriculture, environmental protection, science, space, technology, revenue sharing and other purposes) grew less quickly than revenues at a 10.1% annual rate.

Policies enacted since 1981, as well as unforeseen economic circumstances, have altered these patterns markedly. Annual growth in revenues slowed sharply during the FY81-85 period, due to enactment of tax cuts for individuals and businesses continued in the Economic Recovery Tax Act of 1981 and to the severe 1981-1982 recession. Growth in total outlays slowed during this period, but by far less than revenues, while spending growth for some categories actually accelerated. Table 1 shows that annual growth in defense outlays jumped from 7.4% during the FY65-81 period to 12.5% during the FY81-85, while that for net interest outlays rose from 13.9% to 17.3%. Annual growth in nondefense discretionary spending declined abruptly from 10.1% to 3.3%.

President Reagan's FY86 Budget proposes tax and spending policies which, under the administration's economic assumptions, would result in deficits totaling $705.2 billion during the FY85-88 period. The President's budget envisions 12.2% annual growth in defense spending and 6.9% growth in net interest outlays during the FY85-90 period. Entitlements and other mandatory spending would rise at a 4.5% annual rate while nondefense discretionary spending would actually <u>decline</u> 4.4% annually during this period. This would continue the trend observed during the FY81-84 period of increasing the share of Federal outlays for national defense amid a steady fall in the portion devoted to entitlements and other nondefense discretionary programs (See

Table 1).

TABLE 1. Growth of Revenues and Outlays FY65-90
(Compound annual percentage rates)

	OUTLAYS						
			Non-Defense Spending				
Time Period	Total	Nat'l Defense	Total	Entitle-ments & Othr Mandatory	Non-Def. Discretionary	Net Int.	Offset Receipts
FY65-81	11.3	7.4	13.0	14.8	10.1	13.9	10.6
FY81-85	9.3	12.5	8.0	7.8	3.3	17.3	5.1
Projected*							
FY85-88							
Reagan 2/85	4.5	12.2	1.4	4.0	-7.0	6.9	6.5
CBO 2/85	7.7	11.2	6.4	5.4	4.4	12.7	7.1
Hse Bud Res 5/85	4.2	6.4	3.5	4.3	0.8	5.8	7.1
Sen Bud Res 5/85	3.7	7.5	2.6	3.1	0.5	5.7	8.2

	REVENUES					
Time Period	Total	Ind. Inc. Tax	Corp. Inc. Tax	Social Ins. Tax	Excise Taxes	Other Taxes
FY65-81	10.8	11.7	5.6	14.0	6.6	10.6
FY81-85	5.2	3.9	0.8	9.7	-1.8	5.8
Projected*						
FY85-88						
Reagan 2/85	8.8	9.6	14.2	8.9	-3.2	2.1
CBO 2/85	8.3	9.1	15.1	7.9	-3.6	2.7
Hse Bud Res 5/85	9.1	9.4	17.6	8.8	-2.3	2.1
Sen Bud Res 5/85	9.1	9.4	17.4	9.0	-3.4	2.1

*The Reagan Budget projections assume that the President's FY86 Budget proposal will be enacted while CBO assumes the continuation of current policies.
Source: Congress of the United States. Congressional Budget Offices. The Economic and Budget Outlook: Fiscal Years 1986-1990. A report to the Senate and House Committees on the Budget. February 1985. Executive Office of the President, Office of Management and Budget. Budget of the United States Government FY86. Feb. 4, 1985.

United States Congress. House of Representatives. Report of the Committee on the Budget. First Concurrent Resolution on the Budget--FY86

United States Congress. Senate. Report of the Committee on the Budget. First Concurrent Resolution on the Budget -- FY86. May 1985. March 20 (legislative day, February 18), 1985.

The projected slow rise in net interest outlays is predicated on the optimistic assumption that real interest rates decline significantly; if interest rates are higher, as is assumed by CBO, net interest payments could grow much faster.

The Congressional Budget Office (CBO) projects that the unified budget deficit will rise steadily to $240 billion in FY88 and to $290 billion in FY90 under current policies and economic assumptions that are somewhat less optimistic than those of the Reagan Administration. CBO's projections of nondefense discretionary spending exceed those contained in the Reagan budget because they do not reflect the Administration's proposed cuts in these programs. Similarly, CBO's forecasts of net interest outlays are higher due to higher projected deficits and interest-rate assumptions.

On May 10, the Senate approved its FY86 Budget Resolution by a 50-49 vote. The Senate Resolution (SBR) outlines policies, which would reduce cumulative Federal budget deficits over the FY86-FY88 period by $295 billion under the Senate's economic assumptions. Defense budget authority is allowed to rise with inflation in FY86, then by 3% more than inflation in FY87 and FY88. This contrasts with President Reagan's proposed 8% real annual growth during the same period. Cost-of-Living Adjustments (COLAs) for Social Security, Federal civilian and military pensions, and veterans benefits would be suspended in FY86, a measure not included in the Reagan Budget. Although the Senate version calls for substantial domestic spending reductions and numerous program terminations, some domestic cuts advocated by the Reagan Administration have been scaled back: e.g., Federal subsidies to AMTRAK are to be reduced over the FY86-FY88 period rather than terminated in FY86.

The FY86 House Budget Resolution (HBR) approved on May 23 would reduce Federal Budget deficits from $173.2 billion in FY86 to $124.4 billion in FY88. Under the House plan, budget authority for national defense would remain at its FY85 level in FY86, then rise 3% above inflation in FY87 and FY88. Cost-of-living Adjustments for Social Security, Federal retirement programs and veterans benefits would be provided under current law, in contrast to the Senate Budget Resolution. The HBR recommends less severe reductions in nondefense discretionary programs than does the Senate: the HBR calls for the elimination of one such program -- General Revenue Sharing -- whereas the Senate recommends that thirteen be ended. Table 2 shows deficits, outlays and receipts ensuing from the FY86 Budget Resolutions approved by the Senate and House respectively. The economic assumptions which underly these projections are similar to those of the Reagan Administration shown in Table 3.

Evolution of Budget Forecasts Since 1981

President Reagan amended President Carter's FY82 budget request in February 1981, proposing to cut both revenues and outlays in future years from the levels requested by President Carter, but to cut revenues by more. Based on a forecast for economic recovery and growth that immediately was dubbed "a rosy scenario," the budget was projected to reach balance in FY84. Seven months later, however, after passage of the Economic Recovery Tax Act of 1981 and approval of some, but not all, of the President's requested spending cuts, the Congressional Budget Office (CBO) projected lower revenues, higher outlays, and a $50 billion deficit for FY84 (see Table 2). These changes reflected (1) less rosy assumptions about the economy, (2) the decision of Congress to refuse some of the requested spending cuts, and (3) the enactment of tax reductions larger than the President had proposed.

TABLE 2. Successive projections of unified budget deficits, outlays, and receipts, FY82-88 ($ billions)

Source	1982	1983	1984	1985	1986	1987	1988
Deficits							
Carter - 1/81	-27.5	-8.0	+32.0	+84.7	+138.2	--	--
Reagan - 2/81	-45.0	-22.8	+0.5	+5.8	+28.2	--	--
CBO - 9/81	-60	-65	-55	-50	--	--	--
Reagan - 2/82	-98.6	-91.5	-82.9	-71.9	-66.0	--	--
CBO - 9/82	-111	-155	-152	-152	--	--	--
Reagan - 1/83	110.6 a	-207.7	-188.8	-194.2	-147.7 b	- 142.1 b	--
CBO - 10/83 c	--	-195.4 a	-181	-173	-139 b	--	--
CBO - 8/84	--	--	-172	-178	-195	-216	--
Reagan - 2/85	--	--	-175.4	-209.8	-178.5	-168.2	-148.7
CBO - 2/85	--	--	-175	-203	-206	-225	-240
SBR - 5/85	--	--	--	--	-171.4	-144.8	-104.3
HBR-5/85	--	--	--	--	-173.2	-162.5	-124.4
Outlays							
Carter - 1/81	739.3	817.3	890.3	967.9	1053.3	--	--
Reagan - 2/81	695.3	732.0	770.2	844.0	912.0	--	--
CBO - 9/81	695.3	732.0	770.2	844.0	912.0	--	--
Reagan - 2/82	725.3	757.6	805.9	868.5	927.0	--	--
CBO - 9/82	728	788	844	910	--	--	--
Reagan - 1/83	728.4 a	805.2	848.5	918.5	989.6	1058.4	--
CBO - 10/83	--	795.9 a	858	921	981	--	--
CBO - 8/84	--	--	845	929	1006	1097	--
Reagan - 2/85	--	--	841.8 a	946.6	972.2	1029.9	1099.1
CBO-2/85	--	--	842 a	938	995	1080	1174
SBR-5/85	--	--	--	--	965.0	1011.1	1060.6
HBR-5/85	--	--	--	--	967.2	1028.5	1080.0
Receipts							
Carter - 1/81	711.8	809.2	922.3	1052.6	1188.5	--	--
Reagan - 2/81	650.3	709.1	770.7	849.9	940.2	--	--
CBO - 9/81	655	698	748	--	--	--	--
Reagan - 2/82	626.8	666.1	723.0	796.6	861.0	--	--
CBO - 9/82	618	633	692	757	--	--	--
Reagan - 1/83	617.8 a	597.5	659.7	724.3	841.9 b	916.3 b	--
CBO - 10/83 c	--	600.6 a	677	748	842 b	--	--
CBO - 8/84	--	--	673	751	811	881	--
Reagan-2/85	--	--	666.5 a	736.9	793.7	861.7	950.4
CBO-2/85	--	--	666 a	735	788	855	934
SBR-5/85	--	--	--	--	793.6	866.3	955.9
HBR-5/85	--	--	--	--	794.1	866.0	955.6

* The CBO forecasts assume the continuation of current taxing and spending policies whereas the Carter and Reagan projections assume enactment of the President's policy proposals.

a/ These figures are actual historical results.
b/ These figures include revenues from the contingency surtax proposed for 1986 through 1988 by the Reagan Administration.
c/ Without reserve funding for economic assistance and including a sizeable tax increase in FY86.

As Table 2 shows, President Reagan's FY83 budget, submitted in February 1982, again foresaw sharply lower revenues and slightly higher outlays, this time because the economy had slumped decisively into recession. The deficit was projected to subside only gradually even with a robust economic recovery. Because interest rates in mid-1982 remained high, this prospect aroused calls in Congress and elsewhere for tax increases and more spending curbs to reduce the Federal Government's demands for credit. Even though taxes were increased by an average of about $33 billion per year from FY83 through FY85 by the Tax Equity and Fiscal Responsibility Act of 1982, updated budget projections by CBO in September, 1982, indicated that revenue estimates had been scaled down -- not up -- by more than this amount, due to the prolonged recession. Meanwhile spending projections had been increased by roughly equivalent sums. The deficit was projected to grow to about $150 billion in FY83 and to remain in that range. Projected deficits continued to swell through the end of 1982 as the deepening recession further depressed revenues.

Since the recession's trough in November of 1982, the U.S. economy has experienced one of its strongest recoveries since World War II. Real GNP grew 6.3% in 1983 (on a 4th-quarter over 4th-quarter basis) and 5.9% in 1984, while inflation remained quiescent. Nevertheless, the deficit amounted to 6.1% of GNP in FY83 and 4.9% of GNP in FY84. CBO projects that this share will rise under current policy to 5.3% in FY85 and remain at or above 5.0% throughout the remainder of this decade. These shares would be greater than in any year since World War II, not to mention for several years in succession.

Table 2 shows the unprecedented nature of the current fiscal plight. Receipts and outlays are not expected to approach balance even if the economic expansion continues steadily for 5 or 6 years. Given the three-stage personal tax rate reduction, increasing amounts of business capital eligible for depreciation under generous new formulas, the indexation of the personal income tax brackets and exemption amounts beginning in 1985, and the setback ensuing from the 1981-82 recession, the economy simply cannot generate Federal Government revenues sufficient to catch up with projected outlays without further major changes in budget policies. Even after tax increases enacted since 1982, tax code changes since the advent of the Reagan Presidency resulted in revenue losses of about $99 billion in FY84 and this gap is expected to widen in the future. Recouping such revenue losses would have been difficult even amid steady economic growth throughout the early 1980s, but the long, harsh recession that occurred instead deferred the growth of revenue-raising capacity. Unless additional tax increases or spending reductions are enacted, CBO projects that cumulative deficits over the FY85-90 period will amount to $1.4 trillion.

The Economic Outlook and Current Budget Forecasts

Assumptions regarding future economic conditions profoundly affect projections of Federal revenues, outlays and deficits. Indeed, CBO's most recent baseline budget forecast shows net interest outlays rising to $230 billion in FY90 while the Office of Management and Budget (OMB) projects that this figure will be $164.2 billion. This discrepancy is largely attributable to differences in assumptions regarding interest rates, although it is partly a result of differences in estimation techniques.

How plausible are the economic scenarios set forth by CBO and OMB? What are the implications of alternative scenarios for fiscal policy?

Business Cycles

Conventional business cycle wisdom holds that consumer purchases of housing, automobiles and other big-ticket durable goods lead economic recovery, precipitating increased demand for goods and services and a buildup in business inventories throughout the economy. Inflation rises as the economy approaches full employment. As aggregate demand for goods threatens to strain existing capacity, business investment in plant and equipment rises, which sustains the latter part of the expansion. However, the competing credit demands of consumers and businesses tend to raise interest rates, ultimately slowing both consumption and investment.

The economy's behavior during recession mirrors its rise. As aggregate demand slows, businesses deplete their inventories, rather than placing new orders, further dampening economic activity. Unemployment tends to rise as increasing amounts of capacity are idled, wage and price pressures abate, and interest rates tend to fall.

The Economic Assumptions of CBO and OMB

CBO assumes that real GNP growth slows to 3.5% in 1985 and to 3.2% in 1986, while inflation (as measured by the GNP deflator) accelerates to 4.6% in 1986 (see Table 3). Interest rates (as measured by the 91-day Treasury bill rate) rise in 1986, as is typical of the latter phase of a business cycle expansion.

In its longer-term outlook, CBO assumes a trend growth rate (about 3.4%) for 1987-90 with stable inflation and interest rates. The small decline in unemployment in this scenario is consistent with this modest real growth rate. Furthermore, because unemployment remains above 6% -- the "full-employment" rate above which inflationary pressures are thought to accelerate -- the assumption of stable inflation is plausible. Real interest rates (as measured by the 91-day Treasury bill rate less the increase in the GNP deflator) remain high by historical standards at about 4% throughout this period.

This scenario is predicated on the following assumptions: (1) the current highly stimulative fiscal policy amid restrained growth in the Nation's money supply continues; (2) the exchange value of the dollar remains at its present elevated level throughout the forecast period, and (3) productivity increases almost 2% per year during the 1987-90 period.

The continuation of current fiscal and monetary policies assumed by CBO would serve to keep real interest rates high, as envisioned in this scenario. This would tend to raise or maintain the present high exchange value of the dollar, which acts as a brake on inflation. However, even if U.S. real interest rates remain high, economic recovery and higher real interest rates abroad or a rise in U.S. inflation or a default by a major debtor country, could precipitate decline in the dollar.

Realization of CBO's third assumption would represent a substantial improvement in productivity performance from the 1973-81 era, during which nonfarm business productivity grew at a 0.6% annual rate. Productivity rose 3.9% over the four quarters of 1983, then slowed to 2.4% in 1984; it <u>declined</u> 2.5% during the first quarter of 1985. Thus, it is unclear whether the sluggish productivity growth of the seventies has been fully remedied.

OMB's economic assumptions are considerably more optimistic than those of CBO. Real GNP growth is assumed to remain at about 4% throughout the forecast period while inflation (as measured by the GNP deflator), declines steadily from 4.3% in 1986 to 3.3% in 1990. Interest rates (as measured by the 91-day Treasury bill rate) fall from 8.1% in 1985 to 5.0% in 1990. Such a business expansion would be unprecedented.

A decline in inflation during a long period of strong real growth is implausible, partly because of the normal upward pressures that such a boom would place on wage and price levels. Inflation is projected to continue falling even as the economy nears full employment -- currently considered to be about 6% -- in 1989, and drops below this threshhold in 1990. In addition, even without the rapid decline in interest rates assumed in this forecast, it is likely that the dollar's current high exchange rate, which serves to check inflation by making imports cheap, will decline.

The steady decline in interest rates pictured in this scenario also appears unlikely, given OMB's assumption of continued strong growth. Such growth presumes continually increasing consumption and investment amid heavy Federal borrowing, which would serve to raise credit demand rapidly and, hence, interest rates. The likelihood of a rise in inflation would also serve to boost interest rates, since lenders must be compensated for expected inflation.

However, a decline in interest rates would be plausible, given assumptions of less robust growth. The difference between nominal rates and inflation during 1983 was very high by historical standards, possibly because lenders expected inflation to accelerate eventually. If inflation rises moderately and stabilizes in the near future, interest rates may decline as lenders' expectations of future inflation fall.

The following assumptions underlie the OMB scenario: (1) enactment of the President's FY86 budget request and the continued gradual tightening of money supply growth, (2) strong growth in employment due to assumptions of strong labor-force growth and an assumed decline in the unemployment rate to 5.8% in 1990, (3) real interest rates returning to their long-term levels by the end of the forecast period, and (4) productivity growth of 2% per year during the forecast period.

Even assuming enactment of the President's budget and the realization of OMB's real growth assumptions, budget deficits would remain high by historical standards, which, in conjunction with an ever tightening monetary policy and robustly growing economy, is inconsistent with OMB's assumption of continually declining real interest rates. Moreover, the steadily falling inflation envisioned during the forecast period is implausible given OMB's assumption of rapid increases in employment.

Both the CBO and OMB economic scenarios are optimistic in that they assume no recession during the next 5 years. However, CBO indicates the potential magnitude of the fiscal crisis should a downturn occur in the near future. Assuming that a recession of the same depth and duration as the 1973-75 downturn begins in 1987, and that a similar recovery follows, the FY90 budget deficit would total $425 billion under current policies. (See CBO. The Economic and Budget Outlook -- Part 1. pp. 71, 72-73.)

TABLE 3. The Economic Assumptions of CBO and OMB
(Calendar Years)

	Short-term		Long-term			
	1985	1986	1987	1988	1989	1990
Real GNP						
(Growth (% ch.)						
CBO	3.5	3.2	3.3	3.4	3.4	3.4
OMB	3.9	4.0	4.0	4.0	3.8	3.6
Inflation (% ch.)						
GNP Defl.						
CBO	3.6	4.6	4.4	4.2	4.2	4.2
OMB	4.3	4.3	4.1	3.8	3.5	3.2
CPI						
CBO	3.7	4.5	4.2	4.2	4.2	4.2
OMB	4.2	4.3	4.1	3.8	3.5	3.2
Interest Rates:						
91-day T-Bill (%)						
CBO	8.3	8.7	8.2	8.2	8.2	8.2
OMB	8.1	7.9	7.2	5.9	5.1	5.0
Unemployment (%)						
CBO	7.1	6.9	6.7	6.6	6.4	6.2
OMB	6.9	6.8	6.5	6.2	6.0	5.7

Sources: Executive Office of the President. Office of Management and Budget. Current Budget Estimates.
Apr. 15, 1985. Also, Congress of the United States. Congressional Budget Office. The Economic and Budget Outlook. A Report to the Senate and House Committees on the Budget -- Part 1. February 1985.

POLICY

How serious is the fiscal situation in which the Nation finds itself? How urgent is the need to take forceful action to alter the budget outlook? What kinds of action could be taken?

Implications for the Economy

In FY75, with a 16-month recession ending in the middle of the fiscal year, the Federal deficit rose to 3.1% of GNP and in FY76 to 4.0%. The peak unemployment rate was 9.0% in May, 1975; manufacturing capacity utilization, according to the Federal Reserve Board, fell to 71%. In FY83, by comparison, with an 18-month recession following closely on a brief earlier one, the deficit rose to 6.1% of GNP. Unemployment peaked at 10.7% in December 1982, and nearly one-third of the Nation's manufacturing capacity was idle.

After two recessions in 3 years, separated by only 12 months of recovery, a Federal deficit of this magnitude may have been appropriate in FY83 to forestall further declines in economic activity and help to foster recovery. It is partly a product of the fiscal system's so-called "automatic stabilizers," including the progressive income tax rate structure and the commitment to a substantial degree of income maintenance for the unemployed.

Ironically, the Economic Recovery Tax Act of 1981, passed for quite different purposes, may have constituted one of the most timely countercyclical fiscal actions taken by government since concepts of fiscal stabilization policy were first implemented in the 1950s. It marked one of the few occasions on which deliberate fiscal changes have been made with timing appropriate to slow a recession rather than to speed a recovery. Even greater fiscal stimulus was applied in FY83 largely through the personal income tax cuts.

The aspect of the fiscal situation that causes much concern, however, is that the Federal budget continued to inject stimulus into the economy far beyond the period of economic recovery and into the expansion, and will not retract this stimulus unless further significant actions are taken to narrow the budget gap. Under current policies, the "full-employment" or "structural" deficit (with unemployment hypothetically held constant at 6%) will rise steadily into the later 1980s, signifying heavy fiscal stimulus throughout the period. The persistence of large deficits during periods of economic expansion constitutes a <u>pro-cyclical</u> policy which works to maintain interest rates at extraordinarily high levels and ultimately could aggravate inflation. Such high interest rates handicap credit-dependent industries and, through their influence on exchange rates, hamper trade-related sectors.

Real GNP grew 0.7% during the first quarter of 1985 while the unemployment rate has remained at 7.3% since January 1985. Nevertheless, if the recovery falters, proposals to curtail the deficit sharply in FY86 and after could be timed to aggravate a renewed business cycle downturn. The growth phases of the last seven business cycles have lasted an average of nearly 4 years. Only one expansion -- in the 1960s -- lasted more than 5 years. The present expansion will be 4 years old in late 1986.

The proper timing of fiscal actions therefore is critical. The worst situation would be one in which a new recession occurs before the existing fiscal imbalance is brought under better control. In this case, deficits would rise rapidly from already very high levels with all this would imply for the size of the national debt and interest payments on it. Attempts at such a time to reduce the deficit would tend to be self-defeating and could turn economic recession into depression.

An Evaluation of Proposals to Reduce Deficits

The following sections survey certain deficit-cutting proposals from the many that could be considered. The review is limited to budget impact and does not treat the pros and cons of such measures based upon equity, efficiency, program needs or national defense considerations. Table 4 shows the time patterns of revenues and outlay savings projected to ensue from various deficit-reducing measures. A comprehensive review of proposals to reduce the deficit is presented by CBO in Reducing the Deficit: Spending and Revenue Options. A Report to the Senate and House Committees on the Budget -- Part II.

Tax Increases

Changes in tax policy since 1981 have resulted in substantial net revenue losses over the past three fiscal years. Phased reductions in personal income tax rates, generous depreciation allowances and other provisions of the Economic Recovery Tax Act of 1981 (ERTA) have resulted in cumulative revenue losses of $276 billion during the FY82-84 period. Since 1982, a variety of measures to close tax loopholes, eliminate unintended preferences, ensure the solvency of the Social Security Trust Fund, and raise monies to repair the Nation's highways have generally served to increase revenues. (An exception is the repeal of tax withholding on interest and dividend income, which reduced revenues by $3 billion in FY84.) Despite these actions, Federal tax policy changes since 1981 resulted in net revenue losses of $99 billion in FY84, and this gap is expected to widen to $228 billion in FY90.

Reversal or modification of these policy changes could boost revenues considerably. Raising personal income tax rates by 10% would increase revenues by $83.8 billion, while elimination of indexing would raise $48.7 billion during the FY86-88 period. A less drastic approach would be a 10% increase in marginal rates on income in excess of $70,000 for an individual return and on income over $100,000 for joint returns, which would result in a $14.6 billion gain during this period. Indexing personal income tax brackets by two-thirds of the CPI increase or 2 percentage points less than this increase also would result in significant revenue gains (see Table 4.).

Corporate income tax receipts have declined during the past 3 years, partly because of liberalized depreciation allowances enacted in ERTA. Modification of these rules could increase revenues, while reducing the wide disparities in effective tax rates among different industries, which result under current law. Repeal of the Investment Tax Credit, for which investments in equipment but not those in buildings are eligible, would add $64.8 billion to revenues over the FY86-88 period. Corporate tax receipts could be further enhanced by expanding the existing corporate minimum tax or by imposing a surtax on current corporate tax liability.

The Deficit Reduction Act of 1984 imposed restrictions on the use of industrial development bonds (IDB's). Elimination of all private purpose tax-exempt bonds, including Mortgage Revenue Bonds, Student Loan Bonds and

Hospital Bonds, as well as IDB's, would result in higher revenue gains. A tax on all forms of domestic energy consumption set at 5% of value would swell revenues by $9.8, $14.8 and $15.9 billion over the next 3 years respectively, while a $5-per barrel tax on domestic and imported oil would result in lower but still substantial revenue gains (see Table 4).

Appropriations

The potential for deficit reduction through savings on nondefense discretionary programs is limited by (1) the relatively small share of the budget devoted to such spending; and (2) the fact that spending growth for many such programs has been constrained or reversed during the past 3 years. Still, savings could be achieved by curtailing outlays for transportation, energy, and other federally funded programs. Alternatively, new or increased charges for such program services could be levied on beneficiaries, provided that the identification of users and a collection mechanism were feasible.

Defense spending accounts for a much larger share (30%) of Federal outlays than nondefense discretionary programs, and has experienced substantial real growth in budget authority during the past 4 years. Thus, significant long-term savings could be achieved by limiting the growth of such spending. Reductions in annual outlays could be achieved by lengthening the period over which new weapons systems are purchased, cancellation of certain items, and/or a delay or freeze on military pay raises. In addition, spending increases for operations and maintenance, as well as for research and development, could be constrained. Of course, these decisions involve judgments concerning the appropriate level of defense spending and the optimal allocation of such resources among the various defense activities.

Many kinds of appropriation actions apply only to the current or coming fiscal year and not to those beyond. Thus, while Congress could vote to exclude or limit the general cost-of-living pay increase for Federal employees in FY86, it would be unusual for Congress to make a binding commitment now to do so in FY87 or beyond. In the case of defense procurement, public works, and other such multi-year projects, however, Members of Congress should be aware of the timing with which budget authority approved or cut back this year for big-ticket projects would affect spending throughout the balance of the decade.

Entitlements

This category includes payments for health care (Medicare and Medicaid), Social Security and other retirement and disability programs, unemployment insurance, agricultural price supports, General Revenue Sharing, and others. Outlays for these programs are determined by legislated eligibility criteria and benefit levels in conjunction with prevailing economic conditions. For example, expenditures for Federal retirement programs are directly affected by the age distribution of the population, outlays for Unemployment Insurance depend on the level of unemployment, and the rate of inflation determines cost-of-living adjustments (COLAs) for Federal compensation and retirement pay.

Outlays for programs not involving means test, which include Social Security and Railroad Retirement, Federal Military and Civilian Employee Retirement and Disability, and others, could be substantially reduced by eliminating the automatic COLA for FY86, projected to be 3.7%. This would save $24.4 billion during the FY86-88 period. Limiting annual COLAs to two-thirds of the CPI increase would result in projected savings of $2.2 billion in FY86 and $9.6 billion in FY88, while setting COLAs equal to the CPI minus two percentage points would save $3.6 billion in FY86 and $14.0 billion in FY88. It should be noted that setting COLAs below the CPI increase would result in a steady erosion of beneficiaries' real purchasing power.

Further actions to reduce budget outlays for and to increase revenues flowing into the health care system could result in significant deficit reductions. Employers and employees covered by the Hospital Insurance (HI) program each currently contribute 1.35% of wages and salaries, on the first $39,600 of earnings; taxable earnings ceiling rises automatically with average wages. By raising this contribution to 1.5% in 1986, rather than to the scheduled 1.45%, future deficits would be substantially reduced while maintaining the solvency of the HI trust fund. A variation of one measure passed as part of the Deficit Reduction Act of 1984 would be to increase the share of the program costs covered by Supplementary Medical Insurance (SMI) premiums from 25% to 35%. This would result in cumulative savings of $7.5 billion over the next 3 years.

Elimination of "deficiency payments" to compensate farmers where crop prices fall below target levels would result in cumulative savings of $14.2 billion during the FY86-88 period, if first applied to 1986 crops. Termination of General Revenue Sharing would reduce Federal outlays by $14.2 billion during FY86-88.

The Grace Commission

The President's Private Sector Survey on Cost Control, commonly known as the Grace Commission, has made recommendations which, it claims, would save the Government over $400 billion during an unspecified 3-year period. Although the Commission's original mission was to survey methods for improving efficiency and reducing waste in Government programs, the three largest cost-saving measures would involve substantive policy changes.

A joint study by the Congressional Budget Office (CBO) and the General Accounting Office (GAO) indicates that implementation of many of these proposals during the FY85-87 period would result in savings considerably below the Commission's original estimates. For example, while the Commission estimates that denationalizing Federal power-marketing administrations, such as the Bonneville Power Administration, would yield an estimated $19.1 billion, CBO projects cumulative savings of $1.2 billion over this period. Furthermore, GAO was critical of some policy changes advocated by the Commission, such as the proposal to limit Federal employee's compensation and benefits. Other proposals were too vague for CBO to re-estimate, e.g. the Commission estimated savings from improved management procedures in the procurement process based on their "largely judgmental" assumption that 7% of such costs could be eliminated. [Analysis of the Grace Commission's Major Proposals for Cost Control. A Joint Study by the Congressional Budget Office and General Accounting Office. February 1984.]

A number of the Commission's proposals for which CBO was unable to to estimate budgetary impacts were deemed conceptually sound by the CBO/GAO report. Recommendations for improving Government procurement practices and real property management, especially in defense programs, could result in significant savings. However, more specific proposals are necessary to estimate their budgetary impacts (Analysis of the Grace Commission's Major Proposals, p. 16).

The Deficit Reduction Act included Commission proposals concerning income and eligibility verification procedures, collection and deposit of payments to executive agencies and collection of debts owed to Federal agencies. These measures, aimed at improving government efficiency and management, are projected to yield savings of $3.2 billion over the FY85-87 period.

TABLE 4. Projected results of various measures to reduce the Federal budget deficit
($ billions)

Potential Policy Changes	FY86	FY87	FY88
Revenue Increases			
Raise Marginal Tax Rates 10% (p. 226)	21.1	31.1	32.1
Raise Marginal Rates 10% income over $70,000 for single return, $100,000 for joint return (p. 226)	2.2	5.9	6.5
Repeal Indexing (p. 228)	5.3	15.5	27.9
Index for inflation over 3% (p. 228)	4.3	11.6	20.1
Delay further indexing until Jan. 1987 (p. 228)	5.3	8.7	9.4
Impose Corp. Surtax of (p. 231):			
10%	6.6	11.8	12.7
5%	3.3	5.9	6.4
Impose $5 tax on domestic and imported oil (p. 238)	14.8	21.6	21.9
Impose $5 tax on imported oil (p. 238)	6.6	9.5	9.1
Impose tax on domestic energy consumption (5% of value) (p. 238)	9.8	14.8	15.9
Revise depreciation rules and repeal ITC (p. 246)	15.5	28.4	36.6
Eliminate private-purpose tax-exempt bonds (p. 259)	0.5	1.9	3.6
Increase taxation of non-means-tested entitlement benefits (p. 296)	4.0	11.0	11.8
Reduce tax preferences across the board (p. 303)	8.0	33.0	40.0
Impose 15% alternative minimum corporate tax (p. 304)	3.3	5.5	6.1
	FY86	FY87	FY88

Spending Reductions			
National Defense			
Cancel the MX (p. 66)	1.2	2.3	2.6
Cancel the F-15 (p. 75)	0.4	1.4	2.1
Limit spending for supporting procurement (p. 85)	0.4	2.1	4.5
Limit growth in DoD R&D (p. 87)	3.2	5.7	8.3
Limit FY86 O&M spending to FY85 level (p. 97)	2.9	10.4	17.8
Entitlements			
Limit COLAs for non-means-tested benefits program (p. 135)			
Eliminate COLA for FY86	6.2	9.0	9.3
Limit COLA to 2/3 of CPI for 5 years	2.2	5.8	9.6
Limit COLA to CPI-2 for 5 years	3.6	8.7	14.0
Terminate General Revenue Sharing (p. 151)	3.7	4.8	5.0
Phase out deficiency payments for farmers (p. 159)	0.7	0.3	2.9
Increase SMI premiums to cover 35% of program costs (p. 122)	1.6	2.6	3.3
Increase hospital insurance payroll tax (p. 132)	13.9	19.0	20.5
Nondefense Discretionary Spending			
End eximbank direct loan program (p. 164)	0.3	1.2	1.7
Reduce Federal mass transit aid (p. 182)	0.7	1.1	1.4
Raise aviation user fees to cover Air Traffic Control costs (p. 185)	0.4	0.4	0.5
Initiatives to reduce Federal Government Costs			

Modify Federal Work Force (p. 207)	0.4	0.8	1.2
Eliminate annual pay adjustment for Federal civilian employees (p. 213)	1.5	1.8	1.9

Source: Congress of the United States. Congressional Budget Office. Reducing the Deficit: Spending and Revenue Options. A Report to the Senate and House Committees on the Budget -- Part II.

ADDITIONAL REFERENCE SOURCES

CRS reports dealing with effects of deficits include "Large and Continuing Deficits: Their Influence on Macroeconomic Performance" (Report no. 83-156E) by G. Thomas Woodward (August 1983), and "Do Deficits Influence the Level of Interest Rates?" "Reducing the Federal Deficit: The Macroeconomic Effects of Expenditure Cuts versus Tax Increases" (Report no. 83-47E) by Brian Cashell (January 1983). For information on major congressional actions on the FY85 budget, see Issue Brief entitled "The Federal Budget for FY85" (IB84071), by Philip D. Winters. For a review of proposed major revisions to the U.S. Tax System, see CRS MB84211 -- "Tax Revisions: An Economic Overview" by Donald Kiefer. Various other issue briefs deal with budget requests and congressional actions affecting budgets for particular programs and functions (see CRS Update).