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THE ECONOMY, SMALL BUSINESS AND THE FEDERAL BUDGET

A REPORT

PREPARED FOR THE USE OF THE

JOINT ECONOMIC COMMITTEE
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BY THE

REPUBLICAN STAFF

OF THE

JOINT ECONOMIC COMMITTEE

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LETTER OF TRANSMITTAL

August 1, 1986.

Hon. David R. Obey,
Chairman, Joint Economic Committee,
Congress of the United States, Washington, DC.

Dear Mr. Chairman: I am pleased to submit a report entitled "The Economy, Small Business and the Federal Budget." This report was prepared by the Republican staff of the Joint Economic Committee for the use of the delegates to 1986 White House Conference on Small Business.

As small business people from across the Nation convene in Washington, they will address a wide range of issues. They will make recommendations for government policies that will benefit small business and thus the Nation as a whole. Based on a commonsense approach to decisionmaking, their recommendations are extremely valuable to policymakers in the Government. By presenting information on the economy, small business and the Federal budget, it is hoped that this report will serve as a useful tool to the delgates.

Sincerely,

James Abdnor,
Vice Chairman, Joint Economic Committee.

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THE ECONOMY, SMALL BUSINESS AND THE FEDERAL BUDGET

I. Introduction

Delegates to the White House Conference on Small Business have been and will be addressing a wide range of issues. Small business recommendations for fiscal, tax, monetary, regulatory, and other government policies provide valuable advice to elected and other government officials at all levels.

Small businesses are at the frontlines in the battle for economic prosperity and survival. They are continually confronted with decisions that require information, analysis, and common sense. The purpose of this document is to provide broad-based information on the economy, small business, and the Federal budget. It is hoped that this information will be useful to the delegates as they formulate their recommendations.

II. Economic Indicators, 1980–86

When the White House Conference on Small Business convened in 1980, the American economy was beset by high-interest rates, low growth, and excessive inflation. In an effort to defeat inflation and turn the economy around, the Federal Reserve Board curtailed the growth of the money supply. Many associate this sudden change in economic policy with plunging the Nation into its worst recession in 40 years. In 1982 unemployment rose to almost 10 percent, and growth actually fell in real terms by 2.5 percent. On the brighter side, inflation dropped from a record high of 13 percent in 1979 to a modest 4 percent in 1982. Since 1982, the country has experienced 14 consecutive quarters of uninterrupted growth, while the inflation rate has stabilized around 4 percent. The expansion has been highlighted by a growth rate of 6.4 percent in 1984 and a decline in the unemployment rate to 6.5 percent in January 1986. Table 1 shows the state of the economy from 1980 to 1986 as measured by five broad economic indicators.

TABLE 1.—*Economic Indicators, 1980–86*

[Expressed as percentages]

	1980	1981	1982	1983	1984	1985	1986
GNP growth	−0.2	1.9	−2.5	3.6	6.4	2.7	[1] 3.0
Unemployment rate	7.0	7.5	9.5	9.5	7.4	7.1	[1] 7.0
Inflation rate	12.4	8.9	3.9	3.8	4.0	3.8	[1] 2.0
Prime rate	15.3	18.9	14.9	10.8	12.0	9.9	[2] 8.5
Discount rate	11.8	13.4	11.0	8.5	8.8	7.7	[2] 6.5

[1] Estimate. [2] July 1986.

On balance, the economy improved substantially between 1980 and 1986. The simultaneous decline in inflation and unemployment is unprecedented in U.S. postwar economic history. The dramatic drop in interest rates is particularly important for business to finance inventories and investment. In addition, a return to long-term, fixed rate mortgages has helped provide stimulus and stability to homebuyers and the housing industry.

While the Nation as a whole has prospered during the last four years, the recovery has been uneven. Areas of the country dominated by agriculture, manufacturing, mining, and natural resource industries have lagged behind. Similarly, while small business has benefited from the general decline in interest rates, it still tends to experience higher borrowing costs than indicated by the prime rate.

III. Small Business and the Economy

There is no question that small business plays a vital role in the Nation's economy. Small and medium-sized businesses have proven to be more flexible and adaptable than large businesses. That adaptability is crucial because small businesses are generally the first to experience economic downturns and the first to lead economic recoveries. In addition, small and medium-sized businesses are the Nation's leaders in job creation and innovation.

It is difficult, however, to measure fully the role or contribution of small business in the economy. First, small and medium-sized businesses do not fall into any single, simple definition. They are comprised of sole proprietorships, partnerships, small business corporations, and "regular" corporations. They may be privately owned by family or friends and participate in every industry. In short, they permeate every walk of business life. Second, measuring their role in the economy requires a great deal of detailed information to be completely accurate—a mountain of paperwork would be required to obtain all the necessary information from small and medium-sized businesses.

Notwithstanding these limitations, the Small Business Administration's Office of Advocacy has compiled excellent data classifying businesses by number of employees. For purposes of this discussion, small businesses are classified as those with less than 100 employees; small and medium-sized businesses as those with less than 500 employees. The most recent year for which complete data are available is 1982, although updated data from SBA should be available in the near future.

The Structure of the Economy

Table 2 shows that small business is a major player in the economy.

TABLE 2.—*The Structure of the U.S. Economy*

[In percent]

Size of firm (by number of employees)	Number of firms	Number of employees	Assets	Receipts	Net income
0 to 19 employees	88.0	21.0	9.0	17.0	16.5
20 to 99 employees	10.5	20.0	13.0	16.0	10.2
Subtotal, under 100 employees	98.5	41.0	22.0	33.0	26.7
100 to 499 employees	1.3	12.0	13.0	12.0	8.2
Subtotal, under 500 employees	99.8	53.0	35.0	45.0	34.9
500 or more employees	0.2	47.0	65.0	55.0	65.1
Total, all firms	100.0	100.0	100.0	100.0	100.0

Source: Small Business Administration, Office of Advocacy.

Over 99 percent of all businesses are small and medium sized, and they employ 53 percent of the work force. They own 35 percent of business assets, generating 45 percent of business gross receipts and 35 percent of net profits. In analyzing these statistics, certain characteristics should be noted. First, the concentration of asset ownership may reflect the capital-intensive nature of heavy industry (steel, autos, mining, energy, utilities, etc.) where financial requirements are so large that smaller firms are impractical. Second, the efficiency of small and medium-sized businesses is demonstrated by their relatively high percentage (45 percent) of receipts. Finally, economies of scale exist in large business that may contribute to their relatively larger share of net income.

Small Business Job Creation

Assertions that small business creates the largest share of jobs are well founded. Table 3 presents the growth of jobs between 1976 and 1982 according to the size of firms.

TABLE 3.—*Job Growth by Size of Firm, 1976–82*

[In thousands of jobs]

Size of firm (by number of employees)	Employment				Net increase	Net increase as a percent of total increase
	1976	Net increase	1982	Percent change, 1976–82		
0 to 19 employees	15,597	4,575	20,172	29.3	4,575	38.5
20 to 99 employees	12,834	1,676	14,510	13.1	1,676	14.1
Subtotal, under 100 employees	28,431	6,251	34,682	22.0	6,251	52.6
100 to 499 employees	10,866	1,161	12,027	10.9	1,161	9.8
Subtotal, under 500 employees	39,297	7,412	46,709	18.9	7,412	62.4
500 or more employees	36,664	4,459	41,123	12.2	4,459	37.6
Total, all firms	75,961	11,871	87,832	15.6	11,871	100

Source: Small Business Administration, Office of Advocacy.

Small and medium-sized businesses generated more than three out of every five jobs created between 1976 and 1982. The smallest firms (with less than 20 employees) were the dominating force. They generated 38.5 percent of all the jobs created, more jobs than large business created. In addition, they generated a substantially higher increase in jobs (29.3 percent) than any other classification. These remarkable achievements illustrate the dynamic nature of small business, and that the greatest opportunity for people seeking employment exists in the small business sector.

In December 1985, employment in the U.S. economy reached a record high of nearly 110 million people, with some 10 million new jobs created in the past five years. Job growth in the United States contrasts starkly with that of Europe. According to statistics compiled by the Organization for Economic Cooperation and Development between 1974 and 1984, 14 million jobs were created in the United States while none were created in Europe. In fact, employment in Europe actually declined by nearly 1 million during that period. While these do not correspond precisely with SBA's data and timeframe, it is highly probable that small business was the driving force behind the job creation in the United States.

Small Business in Rural States

While small business plays a vital role in the Nation's economy, it is the lifeline of rural States. Table 4 shows the percentage of jobs provided by each State in 1982 for 16 rural States. These are States in which the rural (nonmetro) population is greater than the city (metro) population.

TABLE 4.—*Small Business Jobs in Rural States, 1982*

State	Percentage of jobs in each State by firm size (in numbers of employees)					
	0–19	20–99	Subtotal under 100	100–499	Subtotal under 500	500 or more
Alaska	31	17	48	12	60	40
Arkansas	25	15	40	13	53	47
Idaho	32	16	48	13	61	39
Iowa	25	15	40	13	53	47
Kansas	27	17	44	13	57	43
Kentucky	21	16	37	11	48	52
Maine	24	18	42	16	58	42
Mississippi	22	16	38	15	53	47
Montana	38	19	57	11	68	32
New Mexico	25	16	41	11	52	48
North Dakota	32	20	52	14	66	34
South Dakota	32	20	52	11	63	37
Vermont	31	21	52	17	69	31
West Virginia	21	16	37	13	50	50
Wyoming	31	21	52	15	67	33
U.S. total	23	16	39	14	53	47

Source: Small Business Administration, Office of Advocacy.

In every rural State except Kentucky, small and medium-sized firms employed at least 50 percent of the nonagricultural work force. In South Dakota, North Dakota, Wyoming, Montana, and Vermont, small and medium-sized firms employed between 63 percent and 69 percent of the work force.

In general, rural areas are more dependent on agriculture, manufacturing, mining, and natural resources industries. As previously indicated, these are sectors of the economy which have participated the least in the economic recovery. With such a large percentage of jobs depending on them, small business in rural States are faced with the difficult task of remaining flexible, adaptable, and productive.

IV. The Federal Government and the Economy

The private sector, of course, is not the only player in the U.S. economy. The Federal Government over the past several decades has increased its prominence in the economy and its influence over economic performance. Federal spending now accounts for nearly one-fourth of gross national product.

Activities of the Federal Government affect small business directly and indirectly in many ways. Taxation and spending undoubtedly are the most visible signs of Federal action. Government regulation—both economic (antitrust laws, e.g.) and social (pollution and safety control, e.g.)—has placed a growing burden on small business over the years. The providing of "public goods" such as highways, airports, defense, and education are a responsibility of government which strengthen our economy. The Government also controls our monetary system, which is crucial to our economic well-being. The late 1970's provide painful evidence of the harm that can come from monetary and fiscal irregularities. These few examples of government duties demonstrate not only the roles of the public sector but also its linkage to the private sector.

It is human nature to want more, and benevolence is an American trademark. Thus, an expanding Federal Government is not suprising. "There's no such thing as a free lunch," however. And, paying for public endeavors is unavoidable, and sometimes very painful. Noble as intentions are, history bears out that the Federal Government is not always the best motivator, the fairest distributor, or the best economic planner for the American people. There are limits—physical, economic, social, and political—to what can be done to improve society as a whole.

Deficits do matter, and many of the financial problems facing small business today can be traced to the budget deficit—the measure of government spending out of control. Both creating and eliminating deficits cause problems for businesses. Deficits are the product of the Government's unwillingness or inability to match spending with revenue. The Government escapes this commonsense responsibility by using its authority to borrow from the private sector enough to cover the shortfall in revenue—or its overgenerosity in spending, depending on your perspective. In any event, government borrowing reaches deeply into the private sector, competing with the private sector for funds available for investment.

To attract the magnitude of funds necessary, it must entice investors with high interest rates. As a result interest rates of all loanable funds are pushed up. The cost of capital to businesses is higher and pressure builds to raise prices. If competitive conditions (stiff import competition, e.g.) prevent increases, business encounters cash-flow problems. It is argued that the costs to business resulting from massive government borrowing far exceed any benefits created by excessive deficit spending.

Eliminating of the deficit can be accomplished by one or a combination of three Federal actions: reducing government spending, increasing revenue (taxes), and/or printing money. The first reduces economic activity by decreasing the demand for goods and services, the second reduces profits, and third creates inflation. As unpleasant as these alternatives are, the disease must be treated. Examining the Federal budget provides insight into how this deficit disease was contracted in the first place. Understanding the budget process may provide a basis for developing, and implementing, the means of gaining control over the deficit.

V. The Federal Budget

The Federal budget is the financial statement produced by the Government each year. While a comprehensive understanding of the budget and the budget process would require knowledge of a complex budget jargon, this discussion is intended only as a general review of key concepts and definitions to provide a basic understanding. The process employed by the Government to arrive at a budget consensus is discussed in Appendix D.

The Government operates on a fiscal year that begins on October 1 and is designated by the calendar year in which it ends. So, fiscal year 1987 begins October 1, 1986, and ends September 30, 1987. The budget is the Government's blueprint for spending, taxing, and borrowing (financing deficits) in a given fiscal year. As such, it illustrates the Government's priorities in a broad sense, while providing considerable detail on how those priorities should be achieved. The budget also serves as an accounting system and, in effect, an annual cash-flow statement.

The dollar amounts of spending in the budget are stated in terms of both "budget authority" and "budget outlays." In general, budget authority is the amount the Government can "contract to purchase" in a given year; budget outlays are the amount of money needed to make payments on the "contracts" for the current and previous years. To illustrate, assume the budget calls for purchasing a piece of equipment for $10,000, to be paid for in two years ($5,000 per year). In the first year, the budget authority is $10,000 (the amount of the "contract") and budget outlays are $5,000 (the actual payment that year). In the second year, there is no budget authority for this piece of equipment, and budget outlays are $5,000 (the final payment). In short, budget authority shows how much the Government plans to spend, while budget outlays show how much and when the money is actually spent. Because outlays are used to calculate deficits, this discussion measures spending in outlays, unless otherwise noted.

The Federal Budget, 1975-87

The budget is divided into 20 numbered functions, each of which combine numerous spending programs according to common goals. For example, there are separate functions for Defense, Agriculture, Education and Training, Health, Social Security, Veterans, Interest on the National Debt, and 13 other functions. The total for each function is the sum of all spending programs in different agencies which contribute to a common goal.

Appendix A shows actual spending by budget function from 1975 to 1985, the most recent complete fiscal year, and estimated spending for 1986 and 1987. The two estimates for 1987 represent: (1) the Congressional Budget Office's (CBO) estimate (under its economic assumptions) if spending programs are not changed, and (2) the spending levels adopted by Congress in the Fiscal Year 1987 Budget Resolution. Changes in current law will be required to achieve the Budget Resolution levels. Appendix A also shows spending, revenues and deficits as a percentage of Gross National Product (GNP) for the same years.

ACTUAL SPENDING IN THE BUDGET

From 1975 to 1986, annual spending grew from $332 billion to $982 billion—an increase of almost 200 percent. During the same time, revenues increased 175 percent (from $279 billion to $770 billion), and deficits increased 300 percent (from $53 billion to $212 billion).

Of the 20 budget functions, the largest five account for over 80 percent of estimated spending in 1986. They are:

Budget function	*Amount (billions)*
Defense	$269
Social Security	200
Interest on the National Debt	139
Income Security	118
Medicare	68
Total	794

THE BUDGET AS A PERCENTAGE OF GNP

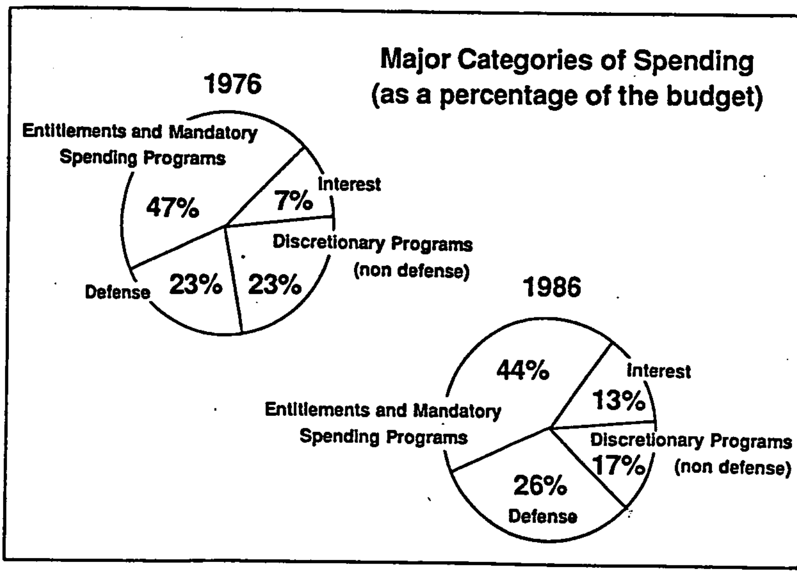
Because the economy grew during the period, the change in spending, revenues, and deficits relative to GNP was not as dramatic as the changes in actual spending, revenues, and deficits. It was, however, substantial. From 1975 to 1980 spending was in the range of 21 percent to 22 percent of GNP. From 1981 to 1986, spending has been mostly in the high end of the range between 23 percent and 24 percent of GNP. The effects of inflation-induced bracket creep pushed revenues above their postwar average of 18.6 percent to 20 percent of GNP in 1981, equaling the postwar high. Following the tax reduction legislation enacted in late 1981, revenues receded to between 18 percent and 18.6 percent of GNP from 1983 to 1986, corresponding roughly to the range prevailing between 1975 and 1978. From 1975 to 1982, deficits were less than 3 percent of GNP except in 1976 (4.4 percent) and 1982 (4.0 percent). The deficit peaked at 6.2 percent of GNP in 1983, but declined to 5.1 percent in 1986.

Estimates for 1987 project a decrease in both spending and deficits as a percentage of GNP and an increase in revenues. The more optimistic estimate, the Budget Resolution, projects spending at 22.1 percent of GNP, revenues at 18.9 percent of GNP and the deficit at 3.2 percent of GNP. It should be noted that actual economic growth in 1987 will affect the result, and that changes in laws to achieve the Budget Resolution's levels for spending, revenues, and the deficit may be required.

Major Categories of Federal Spending, 1975–87

As an alternative to the function-by-function analysis used in the budget process, it is instructive to break down the budget into four major categories of spending. Appendix B presents those four categories in actual spending and as a percentage of the budget from 1975 to 1987.

The following chart illustrates the major categories as a percent of the budget in 1976 and 1986. A description of the categories and a further analysis of Appendix B follows the chart.



DEFENSE

Defense represents the spending for all branches of the Armed Forces and includes spending for compensation for military and civilian employees, operations and maintenance, weapons procurement, research and development, and other programs. A majority of the defense budget is composed of employee compensation and operations and maintenance. From 1976 to 1981, defense spending declined to 23 percent and 22 percent of the budget, the lowest levels during the postwar period. In 1982, defense increased to 24 percent of the budget and was restored to its 1975 level of 25 percent of the budget from 1983 to 1985.

ENTITLEMENTS AND MANDATORY SPENDING PROGRAMS

These are programs that require the Government to make payments, primarily to individuals, to a person who meets the eligibility requirements of the programs. In general, eligibility requirements are common characteristics (age, disability, retirement, military service, etc.) written in the law which, if met, entitle a person to payments. An eligible person can sue the Government if the payment is not made. As a result, the Government is legally required to pay whatever amount is necessary to people who meet the eligibility requirements; the Government cannot arbitrarily limit the total amount spent on these programs without changing the underlying eligibility requirements.

These programs account for the greatest portion of the budget. They comprise 47 percent of the budget in 1976 and 1983; 45 percent or 46 percent in the other years between 1975 and 1983; and 44 percent from 1984 to 1987.

Appendix C presents actual and estimated spending in this category from 1985 to 1987. The programs are separated into "nonmeans-tested" programs (eligibility is not based on financial need) and "means-tested" programs (eligibility based on financial need or level of income). Two nonmeans-tested programs—Social Security and Medicare—accounted for just under 60 percent of all spending in this category. All nonmeans-tested programs represent about 85 percent of total spending for entitlements and mandatory spending programs.

In addition to Social Security and Medicare, this category includes payments for retirement and disability programs for the Federal military and civilian work force; unemployment compensation; veterans benefits and pensions; farm price supports; Medicaid; food stamps; child nutrition programs; student loans, and other programs. Because of the magnitude of spending for this category and the number of individuals who receive their benefits, setting the future level of spending on these programs requires a consensus among current and future recipients.

DISCRETIONARY SPENDING (NONDEFENSE)

Discretionary spending is composed of all the remaining spending programs reflecting the Government's priorities. In general, they are not payments to individuals but represent spending to achieve public or communal goals (good roads and mass transit, environmental protection, education, subsidized housing, job training, etc.). The cost of administering all nondefense programs, both entitlements and discretionary, is included in this category. The actual spending for these programs is set annually in legislation passed by Congress and signed by the President. Unlike entitlements, limits on the total amount spent for these programs can be imposed each year. As a result, these programs have experienced the greatest pressure in efforts to reduce the deficit. Since 1975, discretionary spending has decreased from 24 percent of the budget to 17 percent in 1986.

INTEREST ON THE NATIONAL DEBT

Very simply, this category represents the cost of paying net interest on the cumulative amount the Government has borrowed (by issuing Treasury bills, Treasury notes, and other debt instruments) to finance the sum of deficits in past years. Failure to make these payments would result in default on the Government's obligations. As a percentage of the budget, interest has more than doubled, from 6 percent in 1975 to 13 percent in 1986.

ESTIMATES OF "UNCONTROLLABLE" SPENDING

The estimates for actual spending in 1987 are the amounts needed to pay for programs under current law (assuming the law is not changed) and to honor contracts from previous years. Contractual obligations and compensation paid to military and civilian employees in the Department of Defense have been characterized as relatively "uncontrollable" spending. It has been conservatively estimated that one-half of the Defense budget (13 percent of the entire budget) is "uncontrollable" in this sense. Combining this 13 percent with entitlements (44 percent) and interest on the national debt (13 percent) has led to assertions that 70 percent or more of the budget is on "automatic pilot." In fact, interest on the national debt is the only spending that is uncontrollable as a practical matter. Uncontrollable spending will occur only if no action is taken through laws passed by Congress and signed by the President to stop or reduce the spending. With so much of the budget on "automatic pilot," reducing the deficit is a formidable challenge.

VI. SUMMARY AND OBSERVATIONS

Since the 1980 White House Conference on Small Business, conditions in the overall economy have improved markedly. Interest rates and inflation have declined dramatically, the economy has grown considerably, employment has risen, and the unemployment rate has improved. The economic recovery has not been uniform, however, as evidenced by the difficult times facing agriculture, manufacturing, mining, and natural resources industries.

Small and medium-sized businesses maintained their traditional role as a vital, dynamic force in the economy. Comprising over 99 percent of all firms, small and medium-sized businesses make significant contributions to the economy in terms of assets, gross receipts, and net income. But, their most significant contribution is job creation, where small and medium-sized businesses are the dominant force. In rural States, they are the lifeline of the community and economy and are experiencing major adjustments.

Government policymakers also face a major challenge—reducing and eliminating budget deficits. With so much government spending on "automatic pilot," there are no easy answers or simple solutions. The Gramm-Rudman-Hollings legislation enacted in 1985 imposes a definite schedule for eliminating deficits. If deficits cannot be eliminated by an automatic procedure, they must be confronted directly by making the difficult choices needed to do so. Controlling budget deficits is essential to continued economic prosperity for the

Nation as a whole, and to extending prosperity to all sectors of the economy.

Since 1981, the Congress and the Administration have laid the foundation for stable, steady, and noninflationary economic growth. Adhering to those principles can assure us of a record-breaking period of prosperity. A generation of economic growth is not beyond our grasp. The will and determination of the American people combined with confident leadership can make it a reality.

APPENDIX A

HISTORY OF THE FEDERAL BUDGET, 1975–87

[Total spending (by budget function), revenues, and deficits in billions; total spending, revenues, and deficits as a percentage of GNP]

Budget function No.	Description of function	Fiscal year (actual spending (outlays) in billions of dollars)												1987	
		1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	Estimate, 1986(1)	CBO estimate [2]	Budget resolution [3]
050	Defense	87	90	97	104	116	134	158	185	210	227	253	269	284	279
150	Foreign aid (includes Ex-Im Bank)	7	6	6	7	7	13	13	12	12	16	16	17	15	14
250	General science	4	4	5	5	5	6	6	7	8	8	9	9	9	9
270	Energy	3	4	6	8	9	10	15	14	9	7	6	4	5	4
300	Natural resources and environment	7	8	10	11	12	14	14	13	13	13	13	13	13	13
350	Agriculture	3	3	7	11	11	9	11	16	23	14	26	31	23	24
370	Commerce and housing	10	8	3	6	5	9	8	6	7	7	4	3	4	2
400	Transportation	11	14	15	16	18	21	23	21	21	24	26	28	27	26
450	Community and regional development	4	5	7	12	10	11	11	8	8	8	8	8	8	7
500	Education and training	16	19	21	27	30	32	34	27	27	28	29	31	31	31
550	Health	13	16	17	19	20	23	27	27	29	30	34	36	39	38
570	Medicare	13	16	19	23	26	32	39	47	53	58	66	68	75	73
600	Income security	50	61	61	61	66	87	100	108	123	113	128	118	124	122
650	Social Security	65	74	85	94	104	119	140	156	171	178	189	200	212	209
700	Veterans	17	18	18	19	20	21	23	24	25	26	26	27	27	27
750	Administration of justice	3	3	4	4	4	5	5	5	5	6	6	7	7	7
800	General government	3	3	3	4	4	4	5	5	5	5	5	6	6	5
850	Fiscal assistance (includes revenue sharing).	7	7	10	8	8	9	7	6	6	7	6	6	6	3

900	Interest on national debt	23	27	30	35	43	53	69	85	90	111	129	139	145	144
950	Offsetting receipts (other than taxes) [4]	(14)	(14)	(15)	(16)	(17)	(20)	(28)	(26)	(34)	(32)	(33)	(37)	(37)	(40)
	Total spending	332	372	409	459	503	591	678	746	808	852	946	982	1,025	995
	Revenues	279	298	355	400	463	517	599	618	601	666	734	770	844	852
	Deficit	−53	−74	−54	−59	−40	−74	−79	−128	−207	−185	−212	−212	−181	−143
	As a percentage of GNP:														
	Total spending	21.8	21.9	21.1	21.1	20.5	22.2	22.7	23.7	24.3	23.1	24.0	23.6	23.0	22.1
	Revenues	18.3	17.5	18.4	18.4	18.9	19.4	20.1	19.7	18.1	18.0	18.6	18.5	18.9	18.9
	Deficit	3.5	4.4	2.7	2.7	1.6	2.8	2.6	4.0	6.2	5.1	5.4	5.1	4.1	3.2

[1] Congressional Budget Office estimate, July 1986.

[2] Congressional Budget Office estimate, February 1986 (updated estimates not available at printing).

[3] Spending targets provided in the Budget Resolution for Fiscal Year 1987 (S. Con. Res. 120) passed by Congress. To meet these spending targets (and thus reduce the deficit to $143 billion), changes in the laws that authorize spending programs will be necessary.

[4] Offseting receipts (other than taxes) generally represent collections from the public as a result of the nature of the program or the Government's other activities. Examples include loan repayments, receipts from the sale of property or products, charges for nonregulatory services (user fees) rents and royalties, and the employer share of retirement and disability programs.

NOTE.—Totals may not add due to rounding.

Source: OMB Historical Tables, Budget of the U.S. Government, fiscal year 1987.

Appendix B

FEDERAL SPENDING BY MAJOR CATEGORIES, 1975–87

[In billions of dollars and as a percentage of gross Federal spending]

Major category	1975		1976		1977		1978		1979	
	Billions	Percent of budget	Billions	Percent of budget	Billions	Percent of budget	Billions	Percent of budget	Billions	Percent of budget
Defense	87	25	90	23	97	23	104	22	116	22
Entitlements and mandatory spending programs	157	45	184	47	199	46	220	46	238	45
Discretionary spending (nondefense)	84	24	91	23	105	24	122	25	133	25
Interest on national debt	23	6	27	7	30	7	35	7	43	8
Gross Federal spending	351		392		431		481		530	
Less offsetting receipts [1]	(19)		(20)		(22)		(23)		(26)	
Federal spending	332		372		409		459		504	

Major category	1980		1981		1982		1983	
	Billions	Percent of budget	Billions	Percent of budget	Billions	Percent of budget	Billions	Percent of budget
Defense	134	22	158	22	185	24	210	25
Entitlements and mandatory spending programs	281	45	324	45	360	46	401	47
Discretionary spending (nondefense)	154	25	168	23	153	20	154	18
Interest on national debt	53	8	69	10	85	11	90	11
Gross Federal spending	622		719		783		855	
Less offsetting receipts [1]	(30)		(39)		(37)		(46)	
Federal spending	591		679		746		808	

	1984		1985		Estimated, 1986		Estimated, 1987	
	Billions	Percent of budget	Billions	Percent of budget	Billions	Percent of budget	Billions	Percent of budget
Defense	227	25	253	25	270	26	284	26
Entitlements and mandatory spending programs	397	44	440	44	454	44	474	44
Discretionary spending (nondefense)	162	18	172	17	173	17	174	16
Interest on national debt	111	12	129	13	139	13	145	13
Gross Federal spending	897		994		1,036		1,077	
Less offsetting receipts[1]	(45)		(48)		(49)		(52)	
Federal spending	852		946		986		1,025	

[1] For budgetary accounting purposes, offsetting receipts (other than taxes) reduce gross Federal spending to determine actual spending (outlays). Because the historical composition of offsetting receipts is not available to allocate among the categories, the categories are presented as a percentage of gross Federal spending.

NOTE.—Totals may not add due to rounding.

Source: Congressional Budget Office, "The Economic and Budget Outlook: Fiscal Years 1987-1991."

APPENDIX C

ENTITLEMENTS AND MANDATORY SPENDING PROGRAMS, 1985-86

[In billions of dollars]

	Fiscal year		
	Actual, 1985	Estimated, 1986	Estimated, 1987
Nonmeans-tested programs:			
Retirement and disability programs:			
Social Security	186	197	209
Medicare	70	73	80
Federal, civilian	23	24	26
Federal, military	16	18	18
Other	5	5	5
Subtotal, retirement and disability programs	301	317	338
Unemployment compensation	18	16	17
Veterans' benefits	13	13	13
Farm price supports	18	25	18
General revenue sharing	5	4	4
Social services	3	4	4
Other	17	5	6
Total, non-means-tested programs	374	384	401
Means-tested programs:			
Medicaid	23	24	26
Food stamps	12	12	12
Supplemental security income	10	10	11
Assistance payments	8	9	10
Veteran's pensions	4	4	4
Child nutrition	4	4	4
Guaranteed student loans	3	3	3
Other	2	3	3
Total, means-tested programs	66	70	73
Total, entitlements and mandatory spending programs	440	454	474

NOTE.—Programs presented do not coincide precisely with budget functions; accordingly, minor discrepancies may exist when compared to budget functions.

Source: Congressional Budget Office, "The Economic and Budget Outlook: Fiscal Years 1987-1991."

APPENDIX D

THE BUDGET PROCESS

OVERVIEW AND DEFINITIONS

As previously discussed, the Federal budget illustrates the Government's priorities. Those priorities are ultimately implemented by legislation passed by Congress and signed into law by the President. This discussion presents the general steps in the legislative process that occur to translate the Government's priorities into actual spending and tax policies.

The U.S. Constitution gives the Congress the exclusive authority to allocate the Government's resources. To do so, each year Congress, through the budget process, establishes an overall policy for the level of spending and revenues, and how the spending should be divided among the budget functions. The comprehensive deadlines established to complete specific steps in the process will not be analyzed in this discussion. Rather, the beginning of a new fiscal year on October 1 of each year is the ultimate deadline that will serve as a frame of reference.

At the outset, it may be useful to be familiar with the following definitions:

Budget Resolution.—A resolution passed by Congress that sets annual *targets* for spending, revenues, and deficit levels. It does not become law, so the President's signature is not required. Instead, it is the legislative device Congress uses to regulate itself during the budget process. Accordingly, the Budget Resolution, by itself, does not change the level of spending, revenues, or deficits.

Authorizations Legislation.—Legislation passed by Congress and signed by the President that gives government agencies the legal power to spend. It creates or continues spending programs, establishes the conditions for spending (eligibility requirements, specific projects, etc.), and may place a ceiling on the amount that can actually be spent.

Appropriations Legislation.—Legislation passed by the Congress and signed by the President to actually fund spending programs. Checks are issued by the U.S. Treasury on the basis of appropriations acts. Currently, 13 "regular" appropriations acts are needed to fund spending programs. If one or more of the "regular" acts has not become law before the fiscal year begins on October 1, a "continuing resolution" is necessary until the "regular" acts become law or the fiscal year ends. In addition, "supplemental" appropriations acts provide additional funding for programs that run out of money before the end of the fiscal year.

Reconciliation.—A legislative process to enforce the targets in the Budget Resolution. When the Budget Resolution sets targets for spending, revenues and the deficit that are lower than current law will produce, the Congress must "reconcile" the difference. To do so, the Budget Resolution allocates the spending targets to the House and Senate Committees with jurisdiction over the spending programs. (Note: More than one committee may have jurisdiction over a single budget function. For example, Function 370: Commerce and Housing contains spending for the Small Business Administration, subsidized housing programs and other programs, so the Small Business Committees and the Banking Committees each have jurisdiction.) The committees are then required to draft legislation which changes the spending programs or the tax laws to meet their respective targets. All these drafts are combined into a single package ("reconciliation bill") for the House and Senate to debate, amend, and pass. Differences in the House and Senate bills must be resolved in a conference report adopted by each Chamber and signed by the President.

Gramm-Rudman-Hollings (GRH).—The commonly used term to identify the Balanced Budget and Emergency Deficit Control Act of 1985. Named for its three Senate sponsors, GRH sets maximum limits for deficits that decline until the budget is balanced in 1991. GRH provides specific procedures and enforcement mechanisms to achieve its goals.

Stages in the Budget Process

The President's Budget

In January of each year, the President is required to present Congress with his recommendations for the Federal budget in the fiscal year that begins October 1. The President's budget reflects the Administration's priorities for the Government's fiscal policy and must meet the maximum deficit limits of GRH. It is prepared by the Office of Management and Budget after a lengthy, extensive process of determining the priorities and needs of the individual Federal agencies.

The Congressional Budget Process

After receiving the President's budget, the House and Senate Budget Committees hold public hearings and draft Budget Resolutions setting spending, revenue and deficit targets within the limits of GRH. The Budget Resolutions recommended by the respective Budget Committees are then presented to the full membership of the House and Senate for debate, amendment, and adoption. While amendments normally require a simple majority for adoption, GRH generally requires a three-fifths majority to adopt amendments that would result in deficits exceeding the maximum amounts. In effect, amendments must be "deficit neutral" or be adopted by a three-fifths majority. Differences between the House and Senate Budget Resolutions are frequent, and must be resolved in a conference report adopted by both Chambers.

Authorizations and Appropriations

After adopting the Budget Resolution, Congress is expected to pass authorizations and appropriations legislation (defined above) to achieve the targets in the Budget Resolution. The same legislative process (committee hearings, committee-drafted legislation, etc.) is followed, but the President's signature is required. In addition, amendments must be "deficit neutral" or adopted by a three-fifths majority.

The Congress has less than nine months from the time it receives the President's budget until October 1 of each year when it must adopt and implement the Budget Resolution. Although the last stage of the process (authorizations and appropriations legislation) is scheduled for completion on June 15, the large number of bills that must be enacted separately to complete the process makes it difficult to meet the deadlines. As a result, Congress in recent years has used reconciliation to make changes in the law necessary to implement and enforce the targets in the Budget Resolution. Similarly, Congress has used continuing resolutions to appropriate funds for spending programs.

Gramm-Rudman-Hollings (GRH)

GRH is designed to force Congress and the President to enact legislation that will result in the following maximum deficits:

Fiscal year:	*Billions*
1987	$144
1988	108
1989	72
1990	36
1991	0

If legislation to achieve the maximum deficit is not enacted by a certain date each year, GRH prescribes a detailed mechanism to reduce Federal spending by the amount needed to do so. To illustrate, on August 15, 1986, the deficit is estimated for the 1987 fiscal year (which begins October 1, 1986), taking into account legislation, if any, enacted to achieve the 1987 deficit level. If the estimated deficit exceeds the maximum amount, the difference is the amount of savings required to be realized through the GRH mechanism. That mechanism is a complex formula that ultimately results in reducing spending by a uniform percentage (called "sequestration" or "sequester"). It is not a simple across-the-board percentage reduction of total spending because a significant number of programs have special rules or are exempted from the sequester entirely. Because the sequester formula is so complex, only a general discussion of its key elements is presented here.

One-half of the total required saving is assigned to defense spending. The other half must be achieved by reducing nondefense spending. Up to 50 percent of the total required savings can be achieved by eliminating or reducing Cost of Living Adjustments (COLA's), which are credited as defense and nondefense spending reductions in equal amounts. In general, the sequestration—the uniform percentage reduction—is determined by dividing the amount of spending reduction that is still necessary by the amount of spending that has *not* been (*a*) exempted from reductions entirely, or (*b*) provided special rules for reductions.

The exemptions and special rules are the reasons that *all* spending programs are not reduced by a simple and equal across-the-board percentage. By providing exemptions and special rules, the amount of spending subject to sequestration is reduced substantially. As a result the percentage reduction required of nonexempt programs is larger than it would be if there were no exemptions or special rules. After making the savings from COLA's and applying special rules for nondefense programs (student loans, foster care and adoption assistance, medicare, and certain health care), the sequestration is computed for defense spending and nondefense spending separately.

For defense, no specific program is exempt from sequestration. As with nondefense programs, however, spending for by obligations incurred in previous years is not subject to reduction by sequestration. Even so, the President can achieve all or part of the savings required through sequestration by canceling or modifying existing defense contracts, unless that action would cause a net loss or violate legal obligations. For fiscal year 1987, the Congressional Budget Office (CBO) estimates that $105 billion of defense spending (38 percent of $277 billion total defense spending) will not be subject to sequestration. Accordingly, the remaining $172 billion of defense spending could be reduced by sequestration. The uniform percentage reduction will result from dividing the amount of required defense spending savings by $172 billion.

For nondefense spending, a substantial number of programs are exempt from sequestration. In addition to interest on the national debt, the major exempt programs are Social Security, Veteran's benefits, State unemployment benefits, and most means-tested, low-income entitlement programs (Medicaid, food stamps, child nutrition, etc.). For fiscal year 1987 CBO estimates that $110 billion of nondefense spending (less than 15 percent of $735 billion total nondefense spending) will be subject to sequestration. The uniform percentage for nondefense spending reductions will result from dividing the amount of required nondefense savings by $110 billion.

Because of the exemptions and special rules, it is likely that the percentage reduction for defense spending will be lower (but applied to a larger amount of spending) than the percentage for nondefense spending (applied to a smaller amount of spending). The following example will illustrate.

The maximum deficit under GRH for fiscal year 1987 is $144 billion. CBO projected a deficit of $181.3 billion which would be reduced by $14.7 billion through legislation, resulting in an estimated deficit of $166.6 billion. (Note: More recent estimates project a larger deficit.) Accordingly, the GRH mechanism would reduce the deficit by $22.6 billion ($166.6 billion deficit minus $144 billion maximum equals $22.6 billion) as follows:

	Billions of dollars		
	Defense spending	Nondefense spending	Total
Total required savings	11.3	11.3	22.6
Less:			
COLA savings	−.6	−.6	−1.2
Special rules savings	NA	−1.5	−1.5
Remaining required savings	10.7	9.2	19.9
Spending subject to sequestration	172.0	110.0	282.0
Percentage reduction	6.2 (10.7÷172)	8.4 (9.2÷110)	7.1 (19.9÷282)

Under this estimate, sequestration would result in a 6.2 percent "across-the-board" reduction in nonexempt defense spending and an 8.4 percent "across-the-board" reduction in nonexempt nondefense spending. In sum, those nondefense programs which have not been exempted or provided special rules will bear the greatest percentage reduction if sequestration is needed to reduce spending in order to meet the maximum deficit amount. These programs will be subject to an even greater percentage reduction if the deficit exceeds CBO's estimate, which is probable. At the same time, defense spending will be reduced by one-half of the amount required by the GRH mechanism, even though it accounts for roughly 27 percent of total Federal spending.

As originally enacted, GRH included an "automatic" feature to implement sequestration. In short, the General Accounting Office was directed to calculate the percentage reductions under sequestration, and the President was required to implement them. In early July 1986, however, the U.S. Supreme Court ruled that this feature was unconstitutional. In anticipation of this ruling, GRH included a "fallback" mechanism. In essence, the fallback mechanism is designed to calculate the sequestration reductions in the same manner as discussed above. However, rather than being "automatic," the sequestration would require legislation passed by both the House and the Senate, and signed into law by the President.

As this document goes to print, legislation is being considered to enact an automatic feature that will be upheld as constitutional. Without a new, constitutional automatic feature, the maximum deficit amounts provided in GRH can only be achieved by enacting legislation to do so.

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