STATEMENT OF

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Congressional Budget Office

before the

Committee on the Budget

United States Senate

There should be no release of this statement before its delivery, scheduled for 1:30 p.m. (E.S.T), Tuesday, March 31, 1981.

Mr. Chairman, during the last few years the U.S. economy has performed very poorly, frustrating serious attempts by the Congress to reduce the growth of federal spending and to move away from chronic budget deficits. In 1980 a combination of near record inflation, high unemployment, lagging productivity, and record high interest rates battered the economy. In the spring, we experienced a sharp, though brief, decline in output--the seventh recession since World War II. It increased unemployment and the amount of unused capacity, but did little, if anything, to ease inflation. Moreover, the upturn in economic activity in the second half of the year drove interest rates to new record highs, raising doubts about whether the recovery would be sustained.

In response to the poor performance of the economy, President Reagan proposed a dramatic shift in economic policies designed to reduce inflation, increase economic growth, and balance the budget by 1984. As you know, there are honest differences among economists as to whether the Administration's budget and other policies are likely to produce the favorable effects on the overall economy assumed in the Administration's economic scenario. No one can be certain. Forecasts of the economy and of the budget have not been very accurate. Recent experience does suggest, however, that it is prudent to be prepared for a worse economic performance and larger deficits.

Perhaps more important than the macroeconomic policy, the President's budget proposals involve a fundamental shift in priorities--from nondefense to defense spending and from government to private allocation of resources. The Congressional decision on the proposed shift in priorities need not be bogged down by the controversy over economic forecasts.

The Economic Outlook With Current Policy

Economic growth picked up significantly in the first few months of this year and some forecasters have recently become a little more optimistic about the outlook for 1981. Most forecasters, however, still expect a slowdown in economic activity this spring or summer. Current data that support this view include: income growth, adjusted for inflation, has been weak; consumer confidence has declined; the saving rate has fallen to low levels; housing starts have declined sharply in response to high interest rates; and the sales promotions that have recently boosted auto sales are scheduled to end soon. Weak growth in 1981 is consistent both with the Administration's projection and with the CBO current policy forecast--that is, a forecast incorporating the budget policies of the Second Concurrent Resolution for Fiscal Year 1981. The CBO forecast shows only about 1.8 percent real growth this year (see Table 1).

In regard to 1982, most forecasters expect real economic growth to be less vigorous than does the Administration. Rising

TABLE 1. THE CBO FORECAST BASED ON CURRENT POLICY ASSUMPTIONS

Economic Variable	Actual 1979:4 to 1980:4	Projected 1980:4 to 1981:4	Projected 1981:4 to 1982:4
Nominal GNP (percent change)	9.4	10.0 to 14.0	10.0 to 14.0
Real GNP (1972 dollars, percent change)	-0.3	0.8 to 2.8	1.8 to 3.8
GNP Implicit Deflator (percent change)	9.8	9.0 to 11.0	8.0 to 10.0
Unemployment Rate, End of Period (percent)	7.5	7.3 to 8.3	7.1 to 8.1

interest rates resulting from high inflation, coupled with tight monetary policy, are expected to have a restraining effect on economic growth. CBO's current policy projection also shows a relatively weak recovery in 1982, involving about a 2.8 percent gain in real output, with inflation remaining at near double-digit levels.

Why do we forecast weak real growth? Simply put, because of the continuing momentum of inflation. The present anti-inflationary monetary policy is expected to produce high interest rates as its initial effect, and high interest rates restain growth. A tight monetary policy reduces inflation eventually, but at considerable cost in terms of output and employment. That has been our experience with past episodes of monetary restraint. Of course, economists don't know precisely how long it will take for a tight monetary policy to work, particularly when it is combined with large budget changes. The Administration is more optimistic on this score than most forecasters.

Administration Budget Proposals

The President's budget contains four major changes from current policies:

- A large cutback in nondefense spending relative to the January proposals;
- A substantial increase in defense spending;
- Three 10 percent reductions in marginal tax rates on personal income, phased in over three years; and
- Accelerated tax depreciation of capital expenditures.

The proposed budget is analyzed in detail in the CBO report, An Analysis of President Reagan's Budget Revisions for Fiscal Year 1982, released last week. The CBO economic report released today analyzes the economic outlook under alternative policy options. Since I have previously testified before this Committee on the proposed reductions in spending, my comments today on this topic will be brief.

Spending Changes. The spending proposals represent a radical change in federal fiscal policy (see Table 2). The growth in total

TABLE 2. FEDERAL BUDGET TRENDS (By fiscal year)

	Actual a/	Administration Estimate			
	1977-1980	1981	1982	1983	1984
Percentage Growth					
Revenues	13.3	15.4	8.3	9.0	8.7
Outlays	12.9	13.0	6.1	5.3	5.2
Defense	11.7	19.3	16.5	19.7	13.1
Nondefense	13.3	11.1	2.7	-0.1	1.7
Social safety net	11.0	17.6	8.8	8.9	7.9
Other b/	15.4	0.8	-6.3	-14.2	-8.5
Percent of GNP					
Revenues	19.6	21.1	20.4	19.7	19.3
Outlays	21.7	23.0	21.8	20.3	19.3
Defense	5.1	5.7	5.9	6.3	6.4
Nondefense	16.5	17.3	15.9	14.1	12.9
Relative Composition of Budget Outlays (percent)					
Defense	23.7	24.7	27.2	30.9	33.2
Nondefense	76.3	75.3	72.8	69.1	66.8

a/ Compound annual rates for percentage growth; yearly averages otherwise.

b/ For 1983-1984, the estimates assume that budget savings not yet identified continue to be in the "other" category.

outlays during the next three years would be held below 6 percent per year, compared with compound annual growth of about 13 percent since 1977. The slower spending growth is estimated to reduce total outlays as a share of gross national product (GNP) from 23 percent in 1981 to just over 19 percent by 1984. Although cuts are to be made in nearly all parts of nondefense spending, the largest reductions are in grants to state and local governments.

The Administration also proposes to increase the share of defense spending in the budget from 24.7 percent in 1981 to 33.2 percent in 1984. In real terms, adjusting for inflation, defense spending would grow by an average of over 8 percent per year between 1980 and 1984, whereas nondefense spending would fall to a level 15 percent lower in 1984 than in 1980.

Tax Changes. The President's proposal of three 10 percent reductions in individual income tax rates would reduce taxes by $43.9 billion in fiscal year 1982, and by $172.6 billion in fiscal year 1986, according to CBO estimates. (The tax program is summarized in Table 3.) His proposal to increase business depreciation allowances, a modified version of the 10-5-3 proposal, is estimated to reduce business taxes by $10.8 billion in fiscal year 1982, and by $51.2 billion in fiscal year 1986.

The President's individual income tax cut proposal is essentially the Kemp-Roth bill, without indexing for inflation after the third year. While very large by historical standards, these cuts would approximately offset the higher taxes resulting both from "bracket creep" (the interaction of the progressive tax system and higher nominal income) since the last income tax cut in 1978, and from the legislated increases in Social Security payroll taxes.

TABLE 3. REVENUE EFFECTS OF THE ADMINISTRATION'S TAX CUT PROPOSALS, FISCAL YEARS 1981-1986 (In billions of dollars)

	1981	1982	1983	1984	1985	1986
Administration Tax Cut Proposals a/						
Individual income tax rate cut	-6.4	-43.9	-80.8	-119.9	-146.7	-172.6
Depreciation reform	-2.5	-10.8	-20.3	-30.2	-40.5	-51.2
Tax Increases from:						
Income tax "bracket creep" b/						
Since 1979	15	30	55	85	115	160
Since 1981	--	15	35	60	95	135
1977 Social Security legislation (starting January 1, 1981)	10	22	25	27	39	45

a/ CBO estimates.

b/ Estimated by holding income taxes constant as a percentage of personal income, starting in the base year.

Both the business and the individual income tax cuts are proposed as a means of increasing economic growth. The marginal rate reduction is designed to encourage work in place of leisure and saving in place of consumption, as well as to reduce inefficient--and unproductive--tax avoidance behavior. The depreciation reform will raise the rate of return on investment in productive plant and equipment, encouraging greater business capital formation.

Economic Assumptions with Administration Policies

Estimates of the economic impact of policy changes are always difficult to make. The course of the economy, even without policy changes, cannot be forecast with a high degree of reliability; the effects of policy changes add still more uncertainty, especially when they are as large as those proposed by the Administration. Our analysis, based on historical experience, suggests that, compared with a policy involving no tax or spending cuts, the Administration's proposals would significantly increase real economic growth and reduce unemployment, while causing some upward pressure on inflation, particularly in later years. The inflationary demand pressures from the personal income tax cut would be largely offset by increases in productive capacity, resulting largely from the business tax cuts, together with cuts in federal spending.

The economic scenario used by the Administration, together with an alternative projection prepared by CBO that includes the same tax and spending changes proposed by the Administration, is presented in Table 4. Both the Administration and CBO expect sluggish growth in real output, continued high inflation, and a rising unemployment rate for the remainder of this year. This view of the near-term outlook is shared by most private forecasters and is consistent with the recent weakening of residential construction

TABLE 4. ALTERNATIVE ECONOMIC ASSUMPTIONS (By calendar year)

	1981	1982	1983	1984	1985	1986
GNP (percent change, year over year)						
Administration	11.1	12.8	12.4	10.8	9.8	9.3
CBO Alternative a/	11.8	11.9	11.5	11.4	11.7	10.9
Real GNP (percent change, year over year)						
Administration	1.1	4.2	5.0	4.5	4.2	4.2
CBO Alternative a/	1.3	2.5	2.7	3.0	3.8	3.7
GNP Deflator (percent change, year over year)						
Administration	9.9	8.3	7.0	6.0	5.4	4.9
CBO Alternative a/	10.3	9.2	8.6	8.1	7.5	7.0
CPI (percent change, year over year)						
Administration	11.1	8.3	6.2	5.5	4.7	4.2
CBO Alternative a/	11.3	9.5	8.9	8.2	7.7	7.1
Unemployment Rate (percent, annual average)						
Administration	7.8	7.2	6.6	6.4	6.0	5.6
CBO Alternative a/	7.8	7.9	7.8	7.7	7.5	7.2
3-Month Treasury Bills (percent, annual average)						
Administration	11.1	8.9	7.8	7.0	6.0	5.6
CBO Alternative a/	12.6	13.7	11.5	10.2	9.7	9.3

a/ Based on the Administration's budget assumptions, derived by removing from the current policy baseline all tax changes not already legislated, and then incorporating the effects of the Administration's proposal.

consistent with the recent weakening of residential construction and industrial production. Both projections show positive economic growth and improvement in inflation. However, CBO's alternative projection, which is based on historical experience, is less optimistic. It shows slower improvement in inflation, higher interest rates, less rapid real growth (especially in the near term), and higher unemployment.

CBO's view on prices is based on the postwar experience that, once started, inflation builds up great momentum that can persist through recession. In part, this momentum is sustained by the ability of many wage earners to catch up with rapid inflation that has already occurred, whatever its source and regardless of the state of the labor market. Since labor costs account for roughly three-quarters of total business costs, wage increases that outrun productivity put strong upward pressure on prices.

In the absence of good luck on food and energy prices, restrictive monetary and fiscal policies have been able to slow the momentum of inflation only gradually--and with a significant loss of production and employment in the interim. Last year, for example, relatively tight money, record high interest rates, and credit controls helped induce the seventh postwar recession. But there was little immediate beneficial impact on inflation because wage increases accelerated. The average hourly earnings index rose by 10 percent from January 1980 to January 1981, up from an 8.0 percent rate a year earlier, even though the number of unemployed increased by 1-1/3 million. And the continued rapid rise in consumer prices last year suggests another sharp "catch-up" increase in wages in 1981.

No one, of course, can know the future with certainty, and any economic forecast is subject to a wide margin of error. The economic outlook today is made especially uncertain by two factors: the large size of the fiscal policy changes proposed by the President, and the possibility that--in a period of stagflation--past experience may be a misleading guide to the future.

The outlook with the Administration's economic policies could be more optimistic than the CBO projection for at least three reasons. To begin with, the budget changes--especially the personal tax cuts--could have a greater impact on total productive capacity than historical experience suggests.

If this happens, it is likely to occur through increased saving and work efforts. A cut in marginal income tax rates, such as proposed by the Administration, might have this effect. Using generous assumptions about the way people respond to tax cuts, the proposed reductions in individual income tax rates could raise the productive capacity of the economy by about 3 percent by 1986. This means that the average annual growth of real output could increase by an additional one-half percentage point per year through 1986. Economic growth could be further increased as a result of the distribution of the individual income tax cuts. About four-fifths of the tax relief would go to households earning more than the median income. To the extent that high income groups save proportionally more of added income, the saving response would be more than the historical response to tax cuts.

Second, the tight monetary policy--if it leads people to expect less inflation in the future--could induce a more rapid slowdown in inflation than it has in past experience, with little loss of production and jobs.

Finally, the promised regulatory changes could also reduce inflation and encourage more investment and growth. CBO's projection does not include any effects of deregulation.

On the other hand, the next five years could be worse than historical experience suggests. We could have bad luck with world commodity prices--especially with oil and food prices--as a result of poor weather, unrest in the Middle East, or some other factor beyond our control. Also, the Administration's policies do not allow for secondary effects of the proposed budget cuts. For example, if state and local governments increase their sales or property taxes to offset lost federal grants, the Consumer Price Index would be notched up higher than projected. Finally, the rapid growth of nominal GNP in both projections may be inconsistent with a gradual slowdown in the growth of the money supply--especially if interest rates are also assumed to fall. To be consistent with past experience, such a monetary policy can coexist with substantial real growth only if inflation drops sharply.

Budgetary Implications of Alternative Economic Assumptions

Relative to projections based on historical experience, the Administration's assumptions are optimistic, but certainly not impossible. Nonetheless, it is important for the Congress to understand what the budget might look like if things do not work out as well as envisioned by the President.

Based on its economic assumptions and on some differences in estimating methods, CBO estimates total spending in fiscal year 1982 at more than $25 billion above the Administration estimate; by 1984, that difference increases to about $50 billion (see Table 5). More than half of the added outlays result from the more pessimistic economic assumptions, which cause net interest, indexed retirement benefits, and unemployment compensation to rise significantly more than in the Administration's projection.

Total revenues do not differ significantly in the two estimates because nominal income growth is similar in both sets of assumptions.

TABLE 5. BUDGET PROJECTIONS WITH ALTERNATIVE ECONOMIC ASSUMPTIONS AND ESTIMATING DIFFERENCES (By fiscal year, in billions of dollars)

	1981	1982	1983	1984
Outlays				
Administration	655	695	732	770
CBO Alternative	662	721	766	818
Revenues				
Administration	600	650	709	771
CBO Alternative	599	654	707	769
Surplus or Deficit(-)				
Administraton	-55	-45	-23	1
CBO Alternative	-63	-67	-59	-49

The combination of the alternative economic assumptions and estimating techniques indicates that the deficit may be $65 to $70 billion in fiscal year 1982--more than $20 billion higher than forecast by the Administration. And the budget would still be in deficit in fiscal year 1984--perhaps by nearly $50 billion.

Other Spending Reduction Options

One major omission in the Administration's budget proposals is any change in the way benefit payment programs are indexed to inflation, except for making the cost-of-living adjustment (COLA) for federal employee retirement programs once a year rather than twice a year. Of particular concern are Social Security and various federal civilian and veterans' retirement programs which are explictly indexed to the Consumer Price Index (CPI). These programs will cost over $185 billion in 1981, or close to 30 percent of total federal expenditures. In total, each one-percentage-point increase in the CPI increases federal outlays for indexed benefit programs by about $2 billion a year.

There are a number of reasons why the Congess should consider modifying the indexing of these entitlement programs. First, prices have increased faster than wages during the last several years, and therefore, beneficiaries of these programs have been more fully protected against inflation than have wage earners in general. Second, because of the treatment of homeownership in the CPI, that index has increased faster than the average of all prices faced by the beneficiaries of these programs. Finally, and most importantly, if the rate of inflation comes down more slowly than projected by the Administration, the cost of these programs could be much higher than projected. This would add further pressure to reduce other spending, and would continue to frustrate movement toward a balanced budget.

The policy options for modifying the indexing of benefit payments range from adopting a new index that gives a more representative weight to housing, which was recommended by the Carter Adminstration, to limiting the annual cost-of-living adjustments to less than the full increase of the CPI--possibly to 85 percent of the total increase. Another alternative would be to limit the annual COLA to the lower of the rise in the CPI or a wage index. This latter approach would save an estimated $4.2 billion in 1982 outlays, and $7.2 billion by 1986. It would, however, also lead to lower real benefits.

Other Tax Reduction Options

As I noted earlier, the individual and business tax cuts in the Administration's budget are very large in future years. Locking those tax cuts in now could impose a strong discipline on future spending. But if the Congress is unable to cut spending by amounts that roughly correspond to the size of those tax cuts, the result could be to continue large deficits into the indefinite future.

The Congress could reduce this risk by assuming only the first 10 percent installment of the President's proposed individual tax cut. The effect of a 10 percent rate cut effective October 1, 1981, is shown in Table 6. If the Congress also wanted to scale down the future-year revenue losses from depreciation reform, it could substitute a version similar to the 2-4-7-10 proposal passed by the Senate Finance Committee last year.

Because of uncertainty about the size of the supply effects of the individual income tax cuts, proposals have been made to devote at least a portion of the tax cut to measures that focus more directly on incentives to work, save, and invest. (The revenue effects of some illustrative proposals are shown in Table 6.)

Additional saving could be encouraged by increasing the tax incentives for IRA and Keogh retirement plans. Since there are substantial penalties for withdrawing funds from these plans before retirement, they are more likely to encourage saving that would not otherwise take place than are other saving-incentive proposals.

Eliminating the so-called "marriage penalty" could increase incentives to work for second earners, who are more likely to respond to such incentives than are primary earners.

The efficiency of the investment process could be increased by reducing the top 70 percent marginal tax rate on investment income to 50 percent right away, rather than waiting for three years as the President has proposed. This would reduce the present diversion of resources into tax shelters and other speculative and unproductive investments. It would also reduce the top rate on capital gains from 28 percent to 20 percent, increasing the mobility of capital and making it easier for investors to shift their assets into more productive areas. Capital gains taxes could also be reduced directly by increasing the share of the gain that is excluded from tax.

TABLE 6. REVENUE EFFECTS OF INDIVIDUAL AND BUSINESS TAX CUT OPTIONS, FISCAL YEARS 1982-1986 (In billions of dollars)

	1982	1983	1984	1985	1986
Individual Taxes					
10 percent reduction in individual income tax rates	-33	-39	-46	-55	-64
Limited employee retirement accounts a/	-1	-2	-2	-2	-2
Elimination of marriage penalty b/	-10	-12	-15	-17	-20
Increase in capital gains exclusion to 70 percent	-2	-2	-3	-3	-3
Reduction in top marginal rate to 50 percent c/	-4	-5	-7	-9	-11
Business Taxes					
2-4-7-10 depreciation	-13	-18	-18	-19	-20
Administration depreciation without phase-in	-18	-32	-42	-50	-56
Reduction in top corporate rate from 46 to 44 percent	-4	-4	-4	-5	-5
Partially refundable investment tax credit d/	-3	-3	-4	-4	-5
Refundable 8 percent credit against payroll taxes e/	-6	-7	-8	-9	-10

a/ Allow participants in retirement plans to deduct 15 percent of income up to $15,000 annually for contributions to the plan or an IRA.

b/ Tax credit equal to the marriage penalty on personal service income.

c/ Assumes no change in investor behavior.

d/ Includes outlays.

e/ Employer share only; includes outlays.

A surer way of making certain that a larger portion of the tax cut is devoted to saving and investment, however, would be to increase the business share of the tax cut. Corporations save more than 50 percent of increases in their after-tax incomes, much more than the percentage saved by households. One way of increasing the business share of the cut would be to put the President's depreciation reform proposal into effect right away, rather than phasing it in over five years as he has proposed. This would avoid the potential for delays in investment that might otherwise occur as a result of the phase-in. Other ways of expanding the business tax cut include reducing the top 46 percent corporate tax rate, and making the 10 percent investment tax credit partially refundable. Giving employers an income tax credit equal to some portion of the Social Security taxes they pay would not do much to encourage investment, but it would reduce labor costs, thereby increasing employment and reducing inflation to a modest extent.

Conclusion

Last year, the Budget Committees struggled to curtail the growth in federal spending and to achieve a balanced budget. However, federal spending continues to grow rapidly--in part, because of the poor performance of the economy. The Administration has now proposed a bold new plan for reducing spending growth and redirecting budget priorities that is designed to yield substantial multiyear budgetary savings.

If inflation does not unwind as quickly as the Administration anticipates, however, its proposed spending targets might not be achieved. Spending for indexed benefit programs and for the procurement of defense weapons systems would rise considerably faster than projected. In response to this risk, the Committee may want to consider changes in the way entitlement programs are adjusted for inflation, as well as additional spending cuts. Furthermore, you may want to consider alternative tax cuts--perhaps directing a larger share of the cuts to business or to more direct enhancement of incentives to save.