STATEMENT OF
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BEFORE THE COMMITTEE ON THE BUDGET
UNITED STATES SENATE

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Mr. Chairman, I am pleased to appear before this Committee as you prepare for the difficult task of marking up the Second Concurrent Resolution on the Budget for Fiscal Year 1981. The economy has changed significantly since last March when the Congressional Budget Office (CBO) prepared the forecast on which the first resolution was based. Unemployment is higher than expected, while inflation continues at a very rapid rate and productivity lags. Partly because of the altered economic conditions, the budget deficit is expected to be larger in fiscal year 1980 and a deficit of about $30 billion is now projected for fiscal year 1981--even without any new actions by the Congress. In making decisions on the second resolution, the Committee must again ask itself the tough question: What is appropriate fiscal policy when both unemployment and inflation are high and productivity growth is slow?

RECENT ECONOMIC DEVELOPMENTS

The economy is in its seventh recession since World War II. The drop in economic activity has been exceptionally rapid. Constant-dollar gross national product (GNP) fell at a 9.1 percent annual rate in the second quarter, equaling the sharpest single-quarter contraction of the postwar period. Even with no further deterioration, the 1980 downturn would be about in line with the average peak-to-trough drop in real output during the six previous recessions.

The speed of the recent contraction is also evident in the labor market data. Between February and June, unemployment jumped by 1.7 million workers; total jobs fell by 1.4 million; and the average factory workweek dropped one hour.

To date, the downturn has been concentrated in consumer durable goods, especially automobiles, and in housing. The sharp drop in household spending reflects two major developments. First, disposable incomes have been squeezed by rapid inflation, slow employment growth, rising tax burdens, and higher debt repayments. Second, interest rates shot up to record levels in March and April--and credit conditions became very tight--as the Federal Reserve sought to contain accelerating inflation.

Even though it is difficult to spot developing trends during a period of rapid change, there are indications that the downswing in household spending may be bottoming out:

- Retail sales rebounded in June, in part because automobile sales increased;
- Housing sales and starts, as well as building permits, were up substantially in June; and
- Consumer attitudes about the future have improved somewhat according to recent surveys.

The key to these events is the swift decline of interest rates from their record levels in the spring. Other developments were the dismantling of credit controls and the deceleration in the rate of consumer price inflation.

Unfortunately, these signs of increased household spending do not mean that the recession is over. Overall economic activity is likely to show a further, although more moderate, decline in the current quarter. Business inventories are expected to be worked down to a level more in line with lowered sales expectations, and the recession is likely to spread to other sectors, such as business spending for plant and equipment.

THE CBO FORECAST

Assuming a continuation of the spending and tax policies of the first concurrent resolution, the CBO projects that the recession will end this year and be followed by a relatively weak recovery in 1981 (see Table 1):

- Real GNP is forecast to decrease between 2.3 and 4.3 percent during 1980; about two-thirds of the projected decline has already occurred. During 1981, real GNP is expected to rise between 2.5 and 4.5 percent.

- The unemployment rate is projected to continue to rise this year, reaching 8.4 to 9.4 percent by the fourth quarter, and continuing within this range throughout 1981.

- The GNP deflator is forecast to rise by 8.3 to 10.3 percent during 1980, decelerating to a 7.7 to 9.7 percent range in 1981.

Despite the high level of unemployment projected for 1981, inflation is not expected to slow by very much next year. Rising wages and other business costs, decontrol of domestic oil prices,

TABLE 1. ECONOMIC PROJECTIONS FOR CALENDAR YEARS 1980 AND 1981, BASED ON POLICIES OF THE FIRST BUDGET RESOLUTION FOR FISCAL YEAR 1981

	Levels			Rate of Change (percent)		
Economic Variable	1979:4 (actual)	1980:4	1981:4	1978:4 to 1979:4 (actual)	1979:4 to 1980:4	1980:4 to 1981:4
GNP (billions of current dollars)	2,457	2,547 to 2,648	2,811 to 3,036	9.9	3.7 to 7.8	10.4 to 14.6
Real GNP (billions of 1972 dollars)	1,440	1,378 to 1,407	1,413 to 1,471	1.0	-4.3 to -2.3	2.5 to 4.5
General Price Index (GNP deflator, 1972=100)	171	185 to 188	199 to 206	8.9	8.3 to 10.3	7.7 to 9.7
Consumer Price Index (1967=100)	228	252 to 257	273 to 283	12.7	10.5 to 12.5	8.3 to 10.3
Unemployment Rate (percent)	5.9	8.4 to 9.4	8.4 to 9.4	—	--	--

SOURCE: Congressional Budget Office.

higher social security taxes, and an increased minimum wage are all expected to contribute to the continued momentum of inflation in 1981.

Important uncertainties, of course, cloud the economic outlook. Consumers could resume spending rapidly during the second half of 1980, perhaps causing an upturn in overall activity before the end of the year. Conversely, consumers could hold back more than anticipated, rebuilding their savings anddelaying the recovery until later in 1981. Other factors that would change the forecast include a substantial drop in the exchange value of the dollar, a disruption of imported oil supplies, a major crop failure, or a rapid slide into recession by some of our international trading partners.

THE BUDGET OUTLOOK

The sharp deterioration of the economy has changed the budget outlook considerably from the first resolution. The unexpectedly sharp drop in output and the higher than anticipated rise in unemployment reduce expected federal revenues and increase outlays. We now estimate that the budget deficit for fiscal year 1980 will be over $60 billion, or about $16 billion above the level set in the revised second budget resolution. This change includes a reduction in estimated revenues of about $9 billion and an increase in estimated outlays of over $7 billion (see Table

2). The recession accounts for about $4.5 billion of the increase in outlay estimates and for almost all of the lower revenues for 1980.

The economic downturn this year and the projected modest recovery next year also make it extremely unlikely that the 1981 budget can be balanced as planned under the first budget resolution. Based on our latest economic forecast and a continuation of the tax and spending policies of the first resolution, CBO estimates that the 1981 budget will have a $25 to $35 billion deficit. Lower than expected incomes resulting from the more severe recession will reduce revenues by an estimated $9 to $14 billion below the first resolution target. CBO estimates that 1981 outlays will be up $16 to $21 billion from the first resolution target. Outlays for unemployment insurance, trade adjustment assistance, and public assistance programs are estimated to be about $8 to $10 billion higher than assumed for the first resolution. Higher spending rates for defense and other programs are estimated to add another $13 to $16 billion to 1981 outlays. These outlay increases will be offset somewhat by lower interest costs--about $5 billion less than previously estimated.

TABLE 2. ACTUAL AND PROJECTED FEDERAL BUDGET TOTALS, FISCAL YEARS 1979 TO 1981: IN BILLIONS OF DOLLARS

	1979	1980		1981	
	Actual	Revised Second Resolution	CBO Estimate Based on Actions to Date	First Concurrent Resolution	CBO Estimate with Policies of First Resolution
Receipts	465.9	525.7	517	613.8	600 to 605
(Percent Change)	(15.9)	(12.8)	(11.0)	(16.7)	(16.5)
Outlays	493.7	572.7	580	613.6	630 to 635
(Percent Change)	(9.5)	(16.0)	(17.5)	(7.2)	(9.1)
Deficit (-) or Surplus	-27.7	-47.0	-63	0.2	-25 to -35

CURRENT FISCAL POLICY

Under current budgetary policies, federal fiscal policy would shift dramatically from expansive in 1980 to restrictive in 1981. The growth in total outlays would slow considerably in 1981 under the first resolution spending policies. As shown in Table 2, total federal spending is estimated to rise by 9.1 percent in 1981, as compared with a growth of 17.5 percent in 1980. The deceleration in outlay growth in 1981 is reflected in all major categories of spending except defense.

In contrast, and despite the projected weak economy, we estimate that federal revenues under the first resolution policies will grow at about a 16.5 percent rate next year, as compared with an estimated growth rate of 11 percent for 1980. A large part of the growth in revenues in 1981 results from the scheduled increases in social security taxes, the windfall profits tax on oil, and the rise in effective personal income tax rates because of bracket creep. These three factors alone account for about $37 billion of the $80 billion projected increase in current law revenues for 1981.

The effect of the accelerating revenue growth and the decelerating expenditure growth will be to reduce the size of the budget deficit from over $60 billion in 1980 to about $30 billion in 1981. Reducing the federal deficit in a period of high unemployment tends to restrain economic activity.

The restrictiveness of the 1981 budget under the policies embodied in the first resolution is most evident when we translate these policies to an economy functioning at the full-employment level, or at a constant rate of unemployment. The shift toward restraint in fiscal year 1981 can then be seen as equivalent to a change of almost $70 billion in the budget balance, moving it from a deficit to a surplus. Such a large amount of fiscal restraint during 1981 would retard improvement in the unemployment rate, but at the same time it would contribute to the goal of reduced inflation.

FISCAL POLICY OPTIONS

In considering fiscal policy for fiscal year 1981, the Congress must keep in mind both the short-run and the long-run problems of the economy. The short-run problem is a sharp recession with continuing high inflation. The long-run, more basic problem is an inflation-prone economy with low productivity growth. What is needed to improve productivity is increased saving and investment. There is a risk, however, that efforts to speed up the recovery will emphasize consumption and make the economy less productive in the long run. Ideally, the Congress should strive to design a policy that enhances the recovery without escalating inflation and improves the prospects for investment and productivity. But this is very hard to do.

Thus, the Congress is faced with a difficult series of choices:

First, is the restrictive budgetary policy of the first resolution appropriate, or should the budget be more stimulative? Continuing restraint would hold down the deficit, continue the battle against inflation, but retard recovery. Stimulus--whether tax cuts or spending increases--would enhance the recovery but risk more inflation.

Second, if the Congress wants to alter the budget to offset recession, what policies are available?

- Spending could be increased;
- Individual taxes could be cut; and
- Business taxes could be cut.

Increased spending programs can be targeted to hard-hit areas, but implementation is likely to be slow. The danger is that such programs would take effect when recovery was well on the way, perhaps add to inflation, and do nothing to enhance productivity. An individual tax cut stimulates spending quickly, but it does not directly improve productivity. A business tax cut can increase investment, but it acts slowly and does not relieve the burden of higher income and social security taxes on lower- and middle-income people.

Third, if the Congress decides on a tax cut, when should it be enacted and how big should it be? The timing of enactment is difficult since the need for a prompt response to the worsening economic situation has to be weighed against the time needed to design an appropriate response in a complex situation. A most important factor for the Budget Committees is the size of the revenue loss in 1981 and future years. Various tax cuts have very different outyear effects. A tax cut with large future revenue losses could foreclose budget options and make it far more difficult to achieve budget balance as the economy recovers.

In view of the current focus on tax options in the Congress and the Administration's suggestion that a cut may be needed, what follows is a brief summary of the pros and cons of some of the principal tax options now under discussion.

Personal Tax Cuts

Among the major personal tax cut options now being discussed are:

- An income tax credit equal to some portion of social security taxes;
- A 10 percent across-the-board reduction in personal income tax rates; and
- A tax cut designed to offset the effects of inflation by increasing personal exemptions, the standard deduction (zero bracket amount), and the earned income credit, and widening tax rate brackets.

Credit Against Social Security Taxes. An income tax credit equal to 10 percent *of* social security payroll taxes would reduce revenues by about $10 billion in fiscal year 1981 and about $25 billion in fiscal year 1985 (see Table 3). Both employers and employees would benefit, but those who pay no social security taxes, such as federal workers and the elderly, would not. A 10 percent credit would approximately offset the social security tax increase scheduled for this January. The tax savings would be concentrated on those with low and middle incomes, and on two-earner families (see Table 4).

TABLE 3. REVENUE LOSSES FROM PERSONAL TAX CUT OPTIONS, FISCAL YEARS 1981-1985: IN BILLIONS OF DOLLARS

	1981	1982	1983	1984	1985
10 percent credit against social security taxes	10.3	16.9	19.3	21.8	25.4
10 percent reduction in income tax rates	19.8	35.4	41.8	49.3	58.1
Inflation-offsetting tax cut	14.6	17.2	20.3	24.0	28.3
Illustrative Effects of Components of an Inflation-Offsetting Tax Cut[a]					
10 percent widening of income tax rate brackets	10.3	18.4	21.8	25.7	30.3
$100 increase in the $1,000 personal exemption	2.9	4.7	4.9	5.0	5.2
$100-$200 increase in the standard deduction (zero bracket amount)[b]	0.9	1.5	1.6	1.7	1.8
One percent increase in the earned income credit[c]	1.0	1.1	1.0	0.9	0.9

a. These components of an inflation-offsetting tax cut do not add to the total; they represent only illustrative changes in the various tax provisions.

b. Increase from $2,300 to $2,400 for individuals, and from $3,400 to $3600 for joint returns.

c. Increase from 10 to 11 percent of first $5,000 of earnings, with phase-out at $14,000 of earnings rather than at $10,000.

TABLE 4. DISTRIBUTION BY INCOME CLASS OF TOTAL TAX SAVING FROM PERSONAL TAX CUT OPTIONS: IN PERCENT

Expanded Income Class	Share of Total: Number of Taxable Returns	Share of Total: Tax Payments Under Current Law	Share of Tax Savings From: 10 Percent Social Security Credit	10 Percent Rate Cut	10 Percent Bracket Widening	$100 Personal Exemption Increase	$100-$200 Standard Deduction Increase[a]	EITC Increase[b]
0-10	26.6	3.1	14.6	4.8	7.4	11.4	26.0	65.4
10-20	36.6	19.6	29.8	21.3	20.9	29.4	41.5	34.4
20-30	22.1	24.7	30.2	25.0	25.1	28.7	23.3	0.1
30-50	11.3	24.0	19.8	24.5	26.4	20.9	7.8	0.0
50-100	2.8	14.6	4.6	14.4	14.8	7.6	1.2	0.0
100+	0.6	14.1	1.0	10.0	5.4	2.0	0.1	0.0
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

NOTES: The table reflects 1979 income levels. Details may not add to totals because of rounding.

a. Increase from $2,300 to $2,400 for individuals, and from $3,400 to $3,600 for joint returns.

b. Increase from 10 to 11 percent of first $5,000 of earnings, with phase-out at $14,000 of earnings rather than at $10,000.

A 10 percent credit against social security taxes would have approximately the same economic effects as a rollback of the scheduled 1981 payroll tax increase. Because employers' wage costs would be reduced, inflation would be slightly lower than now projected--the consumer price index would be perhaps 0.2 percentage points lower in 1982.

10 Percent Rate Cut. A 10 percent cut in personal income tax rates would reduce revenues by about $20 billion in fiscal year 1981 and about $58 billion in fiscal 1985. More of the tax savings would go to high-income taxpayers and less to low-income taxpayers than under a social security tax credit (see Table 4).

By reducing marginal tax rates, a tax cut of this kind could increase work and saving incentives, since individuals would be able to keep a larger share of their income from additional work and investments. These effects would probably not be large, however, and they would take place only over a long period. In the shorter run, the tax cut would add to consumer spending and might increase inflation slightly.

Inflation-Offsetting Tax Cut. A tax cut designed to offset the effects of inflation on the individual income tax would widen the rate brackets and increase personal exemptions, the standard deduction, and the earned income credit. A tax cut of this kind would reduce fiscal year 1981 revenues by about $15 billion and fiscal year 1985 revenues by about $28 billion (see Table 3).

This kind of tax cut would assure that those whose incomes increased at no more than the rate of inflation would not have to pay a higher share of their incomes in taxes.

Business Tax Cuts

The major business tax cut options currently under discussion include:

- o Increases in depreciation deductions;
- o Reductions in the corporate tax rate; and
- o Increases in the 10 percent investment tax credit.

10-5-3. The 10-5-3 plan, formally known as the Capital Cost Recovery Act, would significantly increase deductions for depreciation by establishing a simplified depreciation system with much shorter useful lives for most business assets. These higher deductions would encourage additional business investment by helping to offset the effects of inflation on allowances for depreciation. The revenue losses from this proposal would be very large in the outyears, reaching an estimated $4e billion in 1985 and over $80 billion by 1988 (see Table 5). The revenue losses in the early years are substantially lower, partly because the plan would be phased in over a period of five years. This phase-in could, however, significantly reduce investment in the early years

TABLE 5. REVENUE LOSSES FROM BUSINESS TAX CUT OPTIONS, FISCAL YEARS 1981-1985: IN BILLIONS OF DOLLARS

	1981	1982	1983	1984	1985
10-5-3					
With phase-in	3	9	16	28	43
Without phase-in	5	18	32	41	46
Ullman (no phase-in)	2	8	12	14	14
First-year plan[a]	13	31	19	7	0
Expansion of ADR range to 40 percent	—	2	4	6	8
Increase in 10 percent investment tax credit to 11 percent	1	1	1	2	2
Extension of 10 percent investment tax credit to structures	2	3	3	3	4
Reduction in top corporate tax rate from 46 to 44 percent	2	4	5	5	6

a. Includes repeal of investment tax credit. Without repeal, the peak revenue loss in 1982 would be $54 billion.

if businesses postponed investments to wait for the more favorable tax treatment in later years.

Some types of business investment would benefit substantially more under 10-5-3 than others. For most types of equipment, for example, 10-5-3 in combination with the investment tax credit would be more beneficial than not taxing the income from these investments at all. The 10-5-3 plan would increase the rate of return for industrial and commercial buildings, though not by as much as for equipment. Residential rental buildings are not included in 10-5-3 and thus would not benefit at all.

These differences in the treatment of different types of investment could reduce the favorable effects of 10-5-3 on long-run investment and productivity, since they could divert investment resources away from their most productive uses.

Ullman Depreciation Plan. The depreciation plan proposed by Chairman Ullman of the House Ways and Means Committee has the same general objectives as 10-5-3. It would shorten useful lives for all equipment and buildings by at least 35 percent. It would establish four useful life categories for equipment--3, 6, 9, and 12 years--and three for buildings--15, 25, and 30 years. The mechanics of calculating depreciation would be greatly simplified by lumping all assets in each category together rather than requiring that a separate depreciation account be kept for each asset.

The revenue losses from the Ullman plan would be much lower in the outyears than those from 10-5-3, peaking at a level of about $14 billion in 1985.

Jorgenson First-Year Plan. The first-year plan proposed by economist Dale Jorgenson would simplify the calculation of depreciation and would allow the discounted value of all future depreciation deductions for equipment and buildings to be taken in the first year rather than being spread out over the life of the asset. The first-year plan would eliminate any erosion of depreciation deductions by inflation.

The revenue losses from the first-year plan would be very large in the first year or two, since the entire amount of depreciation on new assets that would normally be spread over many years would be taken in the first year. The revenue losses would decline sharply, however, in the later years.

Increase in the Investment Tax Credit. An alternative way of stimulating business investment in equipment would be to increase the investment tax credit. Increasing the credit from 10 to 11 percent would result in a revenue loss of $1 billion in 1981, increasing to $2 billion by 1985. Many firms would not be able to use the additional credit to offset taxes in the year eligible investments are made, however, since their tax liability is less than the credit. In the aggregate, only about half of the extra 1 percent credit could be claimed in the first year.

Increasing the investment tax credit would increase the relative tax disadvantage of investments in buildings, since buildings are not eligible for the investment tax credit. Extending the investment tax credit to commercial, industrial, and residential rental buildings would cost $2 billion in lost revenues in 1981 and $4 billion in 1985.

Corporate Rate Cut. Reducing the top corporate tax rate from 46 to 44 percent would result in tax savings for all incorporated businesses. While only about 13 percent of all businesses are incorporated, they account for about 85 percent of all business income. The revenue losses from a corporate rate cut would not grow as much in future years as those under accelerated depreciation. These losses would rise from about $4 billion in the first full year (1982) to about $6 billion by 1985.

By reducing the top marginal rate on business investment, a corporate rate cut of this kind would encourage additional investment. The stimulus to investment in plant and equipment could be less, however, than from an increase in depreciation or the investment tax credit with the same revenue loss, since the tax saving from a corporate rate cut occurs whether or not a firm makes new investments.

Conclusion

In conclusion, let me emphasize again the basic trade-offs that are involved. Consumption-oriented individual income tax cuts can help the return to full employment in the short term, but they may worsen inflation and use up some of the revenues that could otherwise be used for long-run business tax cuts. Business tax cuts take effect more slowly, and may be more difficult to agree upon in the next few weeks, but they significantly enhance future economic growth. Finally, as always with budgeting, resources are scarce, and large revenue losses in future years may foreclose many tax and spending options.