Statement of Alice M. Rivlin
Director, Congressional Budget Office
before the
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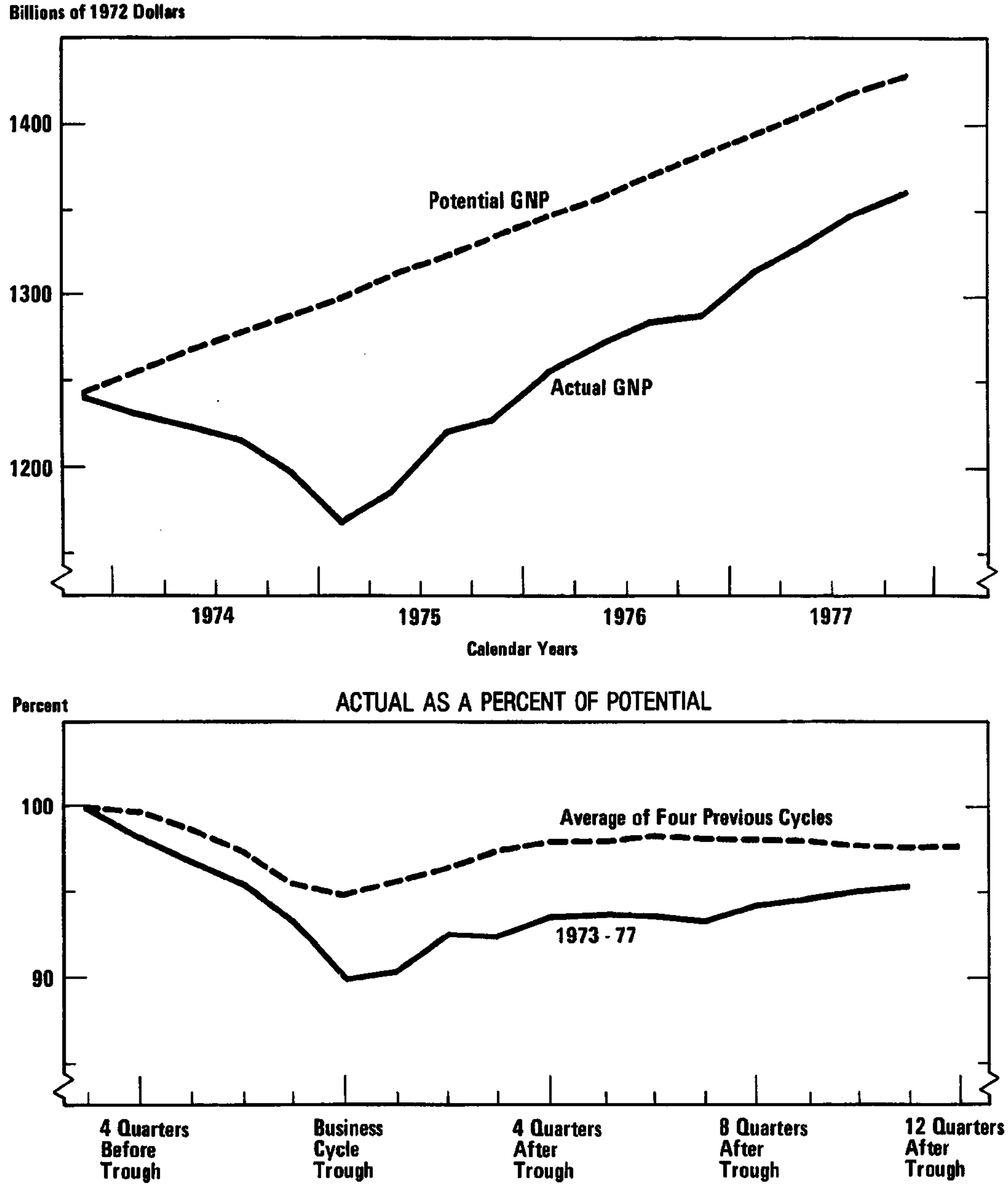
Mr. Chairman, the U. S. economy is now in the twelfth quarter of a recovery from the longest and deepest recession since World War II. The historical record of past recoveries suggests that we should have some concern about the durability of the current expansion. Only one of the five previous recoveries has lasted longer than 15 quarters — an interval that would bring us to the last quarter of 1978 in the current recovery. In fact, an uninterrupted continuation of economic growth to the end of 1979 would make the current expansion longer than any peacetime expansion in the United States in more than a century.

Yet, even with this extended recovery, idle resources in the economy are still large (see Figure 1). Although the gross national product (GNP) appears to have increased 5-3/4 percent in real terms in 1977, leading to a sizable reduction in the unemployment rate (from 7.8 percent in the fourth quarter of 1976 to 6.6 percent in the fourth quarter of 1976), unemployment continues high by historical standards. Moreover, although inflation moderated for a time late in 1977 — largely because of smaller increases in food prices — there appears to have been little improvement in the underlying rate, which is now averaging at least 6 percent.

At the end of 1977, economic indicators were giving conflicting signals about trends in economic activity. Even though

Figure 1.
Actual and Potential Real GNP



SOURCES: Actual GNP – U.S. Department of Commerce, Bureau of Economic Analysis.
Potential GNP – Council of Economic Advisers, Economic Report of the President, 1977.

NOTES: The business cycle trough is the last quarter of recession, as designated by the National Bureau of Economic Research.

growth in real GNP became progressively slower during 1977, final sales, particularly consumer spending, strengthened at year-end. Fairly lean inventories provided a basis for expecting continued gains in output in the near term. Large gains in employment and earnings bode well for consumer spending, although increases in social insurance taxes (and possible energy taxes) will reduce growth in spendable earnings. New orders for capital goods strengthened in late 1977, but surveys reported that businesses were planning smaller increases in capital spending in 1978 than in the preceeding year. And residential construction seemed threatened by rapidly rising interest rates that were already reducing savings flows.

FORECASTING UNDER CURRENT POLICY

Mr. Chairman, a useful starting point for a discussion of appropriate budgetary policy in fiscal year 1979 is a forecast of what is likely to happen to the economy assuming a continuation of current federal budgetary policy. Such a baseline would allow the Committee to consider the type and degree of budgetary changes that are needed to move toward your economic goals for the next fiscal year.

CBO's current policy forecasts (shown in Table 1) indicate that, with a current policy budget for fiscal year 1979, real

TABLE 1. CBO'S ECONOMIC FORECASTS BASED ON CURRENT POLICY: CALENDAR YEARS 1978-1979

Economic Variables	Level			Rates of Change (percent)		
	1977:4 (actual)	1978:4	1979:4	1976:4 to 1977:4 (actual)	1977:4 to 1978:4	1978:4 to 1979:4
GNP (billions of dollars)	1,965	2,150 to 2,190	2,330 to 2,430	11.9	9.4 to 11.5	8.2 to 10.9
GNP (billions of 1972 dollars)	1,361	1,410 to 1,420	1,440 to 1,480	5.7	3.5 to 4.5	2.4 to 3.9
General Price Index (GNP deflator, 1972=100)	144	152 to 154	161 to 164	5.9	5.7 to 6.7	5.7 to 6.7
Unemployment Rate (percent)	6.6	6.0 to 6.5	6.1 to 6.6	—	—	—

economic growth would probably fall below the minimum necessary to allow further reductions in the unemployment rate. Specifically, real growth is projected to slow to a range of 2.4 to 3.9 percent during calendar year 1979 compared with the expected range of 3.5 to 4.5 percent during 1978 and the 5.7 percent rate recorded over calendar year 1977. If these projections are correct, the unemployment rate at the end of calendar year 1979 will probably be between 6.1 and 6.6 percent, essentially unchanged from the reading of 6.4 percent last December. The current policy outlook for inflation is also for little change -- between 5.7 and 6.7 percent in calendar years 1978 and 1979.

Assumptions. These forecasts assume the continuation of tax and expenditure policies that are already legislated or included in the second concurrent resolution. Thus, the effect of rate changes in social security and unemployment insurance are included, but the energy legislation now in conference and the Administration's recently announced fiscal stimulus package are not. With allowances made for expected shortfall, federal outlays on a unified budget basis were assumed to be $455 billion in fiscal year 1978 -- $3 billion below the targets contained in the second concurrent resolution -- and $494 billion in fiscal year 1979.

With respect to monetary policy, the forecast assumes that the growth in the broadly defined money supply (M2) will be near

the upper end of the target range announced by the Federal Reserve Board (the range is 6.5 to 9 percent). In line with recent surveys of business spending, real fixed investment is assumed to increase about 5 percent in 1978. Two critical price assumptions are that consumer food prices will go up 5 percent a year and that wholesale fuel prices will rise about 8 percent a year.

Why the Economy Slows Down under Current Policy. One of the main reasons for the projected slowdown is the restrictive effect of the federal budget itself, largely because of rapid rises in taxes. The recently enacted increases in social security and unemployment insurance taxes would add about $6.5 billion to receipts in fiscal year 1979. In addition, the combination of inflation and the progressive income tax would raise fiscal year 1979 revenues by perhaps another $6 billion.

One useful measure of the impact of the budget on the economy is the change in the full employment budget--the receipts and outlays that would occur if the economy were operating at full employment (arbitrarily defined as 4.9 percent unemployment). CBO estimates that, on a full employment basis, the current policy budget would swing from an $18 billion deficit in fiscal year 1978 to a $3 billion surplus in fiscal year 1979--a $21 billion swing in a restrictive direction.

The increased fiscal drag of the current policy budget is not the only factor likely to slow down aggregate demand.

Consumption spending is likely to show more moderate growth in the next two years than in the past two, because consumers are not expected to reduce their saving rate as they did during the first two years of recovery. Recent surveys of business spending plans also indicate a planned deceleration of capital goods outlays in calendar year 1978. Moreover, with the rise in interest rates threatening flows of funds into thrift institutions, housing starts are not expected to increase much beyond current record levels and are expected to decline later in the year.

The slowdown in growth in fiscal year 1979 cannot be attributed to constraints in supply. This can be seen from projected levels of resource utilization: the unemployment rate with current policy budget is expected to remain some 1 to 1.5 percentage points above the rate that is generally thought to indicate a tight labor market, while capacity utilization rates are projected to remain about 5 percentage points below the last two pre-recession peaks. Consequently, sufficient room for economic expansion still remains before the economy reaches its full potential.

THE ADMINISTRATION'S STIMULUS PROPOSAL

One alternative to current policy that would lead to a greater rate of growth is the Administration's proposal for tax reductions and increased outlays. Of course, this proposal is but one of many options that the Congress could adopt should it

choose to add further stimulus through the budget. On February 6th the CBO will release a report — The Economic Outlook for Fiscal Year 1979 — that will present several other options.

The tax cuts proposed by the Administration would reduce taxes in fiscal year 1979 by approximately $25 billion below current policy levels (as estimated by CBO), and they would reduce taxes in fiscal year 1983 by nearly $35 billion. The net tax cut for individuals in 1979 would be $18.3 billion ($22.5 billion in tax reductions offset by $4.2 billion in reforms), and the net tax cut for corporations would be $5.1 billion ($6.3 billion in reductions offset by $1.1 billion in reforms). In addition, telephone excise and unemployment insurance taxes would be reduced by $1.6 billion. These cuts would be offset by the $1.1 billion in additional revenues in fiscal year 1979 because of the net impact of the energy tax measures included in the Administration's energy plan submitted to the Congress last April.

In terms of outlays, the budget proposed by the President essentially represents a continuation of current policy with few new spending initiatives. Under the budget, outlays would increase by approximately $6 billion in fiscal year 1979, compared with CBO's estimated current policy levels. The principal increases in outlays would be in the areas of education, training, employment, and energy. Some offsetting decreases are also proposed.

The President also proposes a real increase in defense spending. The Administration, however, assumes a lower inflation rate for defense spending than does CBO in our current policy estimates for 1979 — OMB assumes a 6 percent increase, whereas CBO assumes a 7.6 percent increase. If the CBO estimate is correct, the added inflation would eat up the additional defense spending the President proposes, and any real increase would cost more than the Administration estimates..

Fiscal Impact of Proposals. CBO estimates that the Administration's proposals, if enacted, would increase real rates of growth for calendar year 1979 about 1 percentage point from a current policy range of 2.6 to 4.0 percent (see Table 2). A reduction in the unemployment rate of perhaps 0.3 percentage points in 1979 is forecast if the Administration's package is accepted. The number of people employed would increase by about a half a million. The rate of inflation would probably not be significantly affected in 1979 by the economic impact of the President's proposal,.because the inflationary effects of such additional expenditures and tax cuts tend to build up more slowly than the effects on real activity. The energy program would add to inflation in 1979, however, and by the end of calendar year 1979, the entire proposal would raise the price level by perhaps 1 percentage point.

A comparison of the forecasts by CBO and the Administration of the effect of the President's budget is given in Table 2. The Administration's forecast of 4.7 percent real economic growth from

TABLE 2. COMPARISON OF ADMINISTRATION AND CBO ECONOMIC FORECASTS: BY CALENDAR YEARS a/

	CBO Current Policy Forecast	CBO Forecast With Administration Fiscal Policy Proposals	Administration Forecast of Its Policy
Economic Growth (percent change in constant dollar GNP)			
1977 to 1978	4.0 to 5.0	3.9 to 4.9	4.7
1978 to 1979	2.6 to 4.0	3.5 to 4.9	4.8
Inflation (percent change in the implicit price deflator)			
1977 to 1978	5.6 to 6.6	5.9 to 6.9	6.1
1978 to 1979	5.7 to 6.7	6.3 to 7.3	6.2
Unemployment Rate (percent)			
1978:4	6.0 to 6.5	6.0 to 6.6	6.2
1979:4	6.1 to 6.6	5.7 to 6.3	5.8

a/ The GNP estimates in this table are on a calendar year basis. Therefore, the current policy estimates are not directly comparable with those in Table 1 which are on a fourth-quarter calendar year basis. Calendar year estimates were used here so that the Administration's forecast — which is only available on a calendar year basis — could be included for comparison.

1977 to 1978 and 4.8 percent growth from 1978 to 1979 is at the high end of the CBO range. The Administration's forecasts of unemployment and inflation are also at the optimistic end of the CBO range.

Longer-Run Budget Outlook. The Administration's longer-run budget and economic goals include a balanced budget in 1981, a reduction of unemployment to 4 percent by 1983, and a reduction in the rate of inflation to 4 percent, also by 1983. These goals are very optimistic. Achieving any of them will not be easy. Achieving all of them simultaneously appears highly unlikely.

To bring about the desired reduction in unemployment without very large special employment programs, which are not proposed by the Administration and which would present difficulties of their own, would take five years of real economic growth averaging between 4.5 and 5 percent a year. OMB apparently believes these growth rates are consistent with a decline in the inflation rate to about 4 percent by 1983; CBO estimates indicate that inflation is more likely to remain close to 6 percent if recovery is sustained at this healthy rate. Moreover, even if the nonfederal sectors of the economy grow at rates that are slightly above their post-World War II average, CBO anticipates that further tax cuts or spending increases after fiscal year 1979 will be necessary to avoid a slowdown in overall growth.

These additional tax cuts or spending increases would jeopardize the goal of a balanced budget. CBO estimates that, unless

the performance of the nonfederal sectors is far beyond historical norms, attaining the Administration's announced growth and unemployment targets is likely to require a deficit of around $40 billion to $50 billion in 1981 and to preclude balance until 1983 or later. Indeed, the President himself has suggested in his Economic Report that the Administration's goals might be overly optimistic and that further tax cuts beyond those now proposed might be needed.

CONTROLLING INFLATION

At present, the underlying inflation rate remains around 6 percent. In general, the CBO concurs with the President that the current rate of inflation is largely a heritage of the late 1960s and early 1970s. Winding down inflation once it starts is a slow and difficult process. Further, attempting to reduce inflation by holding down overall economic activity is extremely costly--particularly now, when unemployment remains high and the rate of utilization of plant and equipment capacity low--and unlikely to be effective.

A number of possible policies, however, including several proposed by the Administration, may help reduce inflation without causing additional unemployment. Some of these attempt to improve opportunities for translating increases in aggregate demand into increased production and employment rather than into higher prices. They include:

- o Encouragement of capital investment. The Administration intends to accomplish this with its proposed tax changes. Initially, increased spending for capital goods adds to demand-induced inflationary pressure, but when the investment is in place it helps to increase productivity and this, in turn, helps to reduce inflationary pressures.
- o Job and training programs targeted on groups and areas with high incidence of structural unemployment. A number of the programs proposed by the Administration move in this direction. It should be noted, however, that such programs accomplish little for the unskilled unless employment opportunities are plentiful.

Other policies attempt to control inflation more directly. These may range from wage and price controls through quantitative guidelines for wage and price increases, to more general guidelines for wage and price increases, to more general exhortation or consultation on wage and price changes. Wage and price controls have worked in the United States during wartime, and they apparently reduced inflation for a time in the early 1970s, although much of the effect may have been to postpone price increases rather than to avoid them. There is some evidence that guidelines were successful in reducing inflation in the mid-1960s.

The President currently proposes that, "major firms and unions respond to requests from members of my administration to

discuss with them on an informal basis steps that can be taken during the coming year to achieve deceleration in their industries." It is impossible at this time to estimate how successful this effort will be.

In addition, there are numerous ways in which governmental action at all levels — state and local as well as federal — might mitigate inflation. For example:

- o The President has proposed repeal of the telephone excise tax and reduction of the rate of the federal unemployment tax. Although these taxes are small, they add marginally to inflation because they are costs of doing business. The telephone tax also enters the consumer price index directly.
- o The Administration has also discussed the possibility of decreasing economic regulation. To the extent that such regulation decreases competition, it cuts back on the single most effective control over prices in our market system. Other forms of regulation, such as those for environmental protection and occupational safety, also have inflationary effect.
- o Some economists have proposed federal incentives to the states and localities to cut down on sales taxes, which also enter consumer prices; some have even proposed income tax incentives to employers and workers to keep wage increases down.

- One of the major components of inflation in the last decade has been accelerating health-care costs, and a major cause of this has been the massive entry of the federal government into the health-care business since the mid-1960s. Federal efforts to control both public and private health-care costs could have anti-inflationary effects.
- The President's energy program will increase inflation in the near term by raising energy prices. This may be offset later by the favorable effects of an oil reserve and the decreased vulnerability to increases in oil prices that are out of our control.
- Barriers to foreign competition with American producers can also lead to higher prices for American consumers. Current and proposed changes in tariffs and trading practices should be examined in this light.
- Support of farm prices contributes to increases in food prices in the near term, but the building of a grain reserve can ultimately help protect our economy from sharp price increases like those of 1972.
- Increasing the minimum wage is generally thought to add to inflationary pressures.

In view of the intractable nature of inflation and the diverse and lengthy list of governmental actions that might accelerate or reduce inflation, it might be useful for the Congress to ask a governmental agency, possibly even the CBO, to monitor and report periodically on governmental actions that have substantially affected or might be expected to affect the rate of inflation.

Mr. Chairman, I understand from your letter of invitation that the Committee is interested in several other matters that relate to fiscal policy and the first concurrent resolution. Not all of them have been covered in this testimony, but I hope the CBO can provide the necessary information as you move toward decisions on the fiscal year 1979 budget. Thank you.