

STATEMENT OF
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Congressional Budget Office
before the
Committee on the Budget
U.S. House of Representatives

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Mr. Chairman, the President has proposed a dramatic change in government policies designed to reduce inflation, stimulate economic growth, and reverse the increase in the federal government's share of national output. The centerpiece of his economic package is the budget. My testimony today will describe the Administration's budget plan and the economic assumptions upon which it is based. I shall then discuss the consequences of using alternative economic assumptions for estimating total spending and revenues and conclude with some alternative policies that the Committee may want to consider.

Administration Budget Proposals

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

- o A large cutback in nondefense spending;
- o A substantial increase in defense spending;
- o A 30 percent reduction in marginal tax rates on personal income, phased in over three years; and
- o 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 today.

Spending Changes. The spending proposals represent a radical change in federal fiscal policy (see Table 1). The growth in total outlays during the next three years would be held below 6 percent per year, compared to an average annual growth of about 13 percent since 1977. The slower spending growth is estimated to reduce

TABLE 1. FEDERAL BUDGET TRENDS (By fiscal year)

	Actual <u>a/</u>	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 <u>b/</u>	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/ Average 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.

total outlays as a share of gross national product (GNP) from 23 percent in 1981 to just over 19 percent by 1984.

The Administration also proposes to increase the share of defense 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.

For defense, the Administration has increased the amounts requested in the appropriation supplemental for fiscal year 1981 and asked for substantially more spending authority in 1982 than proposed by the previous Administration. Most of the added funds are for procurement programs, almost entirely for weapons already in production. The Administration also proposes a 5.3 percent pay raise for all military personnel in July 1981 in addition to the 9.1 percent October 1981 pay raise assumed in the January budget. Large increases in defense funds are projected for 1983 and 1984 as well, but few details have been provided about how these additional funds would be used. The Administration has also indicated that it would request additional defense funds if inflation turns out to be higher than projected.

Several nondefense programs that have been expanding rapidly were exempted from the proposed spending reductions--including

basic Social Security benefits for the elderly, Medicare, railroad retirement, unemployment insurance, supplemental security income, and certain veterans' benefits. The Administration estimates that outlays for these programs--referred to as the "social safety net"--will increase by 2.5 percent per year in real terms between 1980 and 1984, and will constitute about 40 percent of total spending by 1984. Most of the "safety-net" benefits are indexed directly or indirectly for inflation.

Almost all of the proposed reductions focus on the approximately 30 percent of the budget that remains after excluding expenditures for defense, the social safety net, and net interest costs. This portion consists mainly of programs for education, employment and training, food, nutrition, health, social services, energy, community and regional development, and transportation. Assuming that budget savings yet to be identified continue to be in these areas, the Administration's proposals would reduce spending in this portion of the budget by an average of about 10 percent per year in real terms between 1980 and 1984.

Approximately one-third of the reductions from the January budget are in grants to state and local governments. The cuts are to be made by tightening eligibility criteria, eliminating and reducing some programs, and consolidating outlays for others into block grants.

Tax Changes. The President's proposed three-year 30-percent reduction in individual income tax rates is estimated to 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 2.) His proposal to increase business depreciation allowances is estimated to reduce business taxes by \$10.8 billion in fiscal year 1982, and by \$51.2 billion in fiscal year 1986.

TABLE 2. 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.

The President's individual income tax cut is essentially the Kemp-Roth bill without indexing for inflation after the third year. While very large by historical standards, the President's proposed cuts 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.

The President's depreciation reform proposal is a somewhat modified version of the 10-5-3 plan initiated by Chairman Jones and Congressman Conable. It also includes provisions for real estate depreciation similar to those approved last year by the Senate Finance Committee in its 2-4-7-10 depreciation proposal. The revenue losses from the President's proposal would be relatively low at first, because the proposal is phased in over five years, but the losses would then rise to an annual level of about \$85 billion before leveling off around 1989.

Both 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--perhaps illegal--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

Any budget projection depends importantly on what is assumed about the economy. Table 3 presents the economic assumptions used by the Administration, together with an alternative set prepared by CBO. The alternative economic assumptions have factored in the tax and spending changes proposed by the Administration.

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 and industrial production.

The differences between the two sets of economic assumptions become more significant in 1982 and continue through 1986. CBO's alternative projection, which is based on historical experience, shows slower improvement in inflation, higher interest rates, less rapid real growth (especially in the near term), and higher unemployment.

CBO's more pessimistic outlook on prices is based on the postwar experience that, once started, inflation builds up great

TABLE 3. 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 <u>a/</u>	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 <u>a/</u>	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 <u>a/</u>	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 <u>a/</u>	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 <u>a/</u>	7.8	7.8	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 <u>a/</u>	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.

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 since wage increases accelerated. The average hourly earnings index rose by 10 percent from January 1980 to January 1981, up from a 7.7 percent gain a year earlier, even though the number of unemployed increased by 1-1/2 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. First, the budget changes--especially the personal tax cuts--could have a greater impact on total productive capacity than historical experience suggests. Second, the tight monetary policy--by operating directly on price expectations--could induce a quick slowdown in inflation with little loss of production and jobs. Third, the promised regulatory changes could reduce inflation and encourage more investment and growth.

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 for oil and food--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 CPI would be higher than projected. Finally, the rapid growth in 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.

Budget Implications of Alternative Economic Assumptions

Relative to projections based on historical experience, the Administration's assumptions are optimistic, but certainly not impossible. In any case, 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 more pessimistic economic assumptions and on some differences in estimating methods, CBO estimates total spending in fiscal year 1982 to be more than \$25 billion above the Administration estimate; by 1984, that difference increases to about \$50 billion (see Table 4). 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 4. 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(-)				
Administration	-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 by 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 explicitly 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. For example, the July 1980 cost-of-living adjustment for Social Security was 14.3 percent, and this alone added \$17 billion to fiscal year 1981 outlays. 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 Congress 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 unusually large weight given to new housing 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 predicted. 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 run the gamut from adopting a new index that gives a more representative weight to housing, which was recommended by the Carter Administration, 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.

CBO analyzed several other possible budget reductions in a report Reducing the Federal Budget: Strategies and Examples, which I presented to this Committee on February 3rd. Those include reducing operating and construction subsidies for the maritime industry, moving toward private financing of the Strategic Petroleum Reserve, providing incentives for hospital cost containment, making general aviation pay its full share of airport costs, and eliminating farm deficiency payments. Such options could be considered either in place of or in addition to the President's proposed budget reductions.

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.

To reduce this risk, the Congress could approve 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 5. 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.

The cuts in marginal income tax rates the President has proposed should increase incentives for saving and work, and reduce some of the investment distortions that result from very high marginal tax rates. Because of uncertainty about the size of these effects, however, 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 5.)

Additional saving could be encouraged by increasing the tax incentives for IRA and Keough retirement plans. Since there are

TABLE 5. 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 <u>a/</u>	-1	-2	-2	-2	-2
Elimination of marriage penalty <u>b/</u>	-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 <u>c/</u>	-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 <u>d/</u>	-3	-3	-4	-4	-5
Refundable 8 percent credit against payroll taxes <u>e/</u>	-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.

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 proposals that mainly encourage shifting of short-term savings from one form to another.

Eliminating the so-called "marriage penalty" on two-earner married couples 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.

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

The Budget Committees and the entire Congress have struggled valiantly to curtail the growth in federal spending and to achieve a balanced budget. It is very hard, however, to undo or modify one by one the steps that have led to greater spending. The Administration has proposed a bold plan for reducing spending growth and redirecting budget priorities that is designed to yield substantial multiyear budgetary savings.

A major risk to achieving the spending targets proposed by the Administration is that inflation may not unwind as quickly as

anticipated. This would cause spending for indexed benefit programs and for the procurement of defense weapons systems to 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.