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Before the
Committee on Appropriations
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Mr. Chairman, I am pleased to appear before this Committee as you prepare to make specific decisions on the Administration's appropriation requests for fiscal year 1983 and proposed supplementals and rescissions for the current fiscal year. The Congressional Budget Office (CBO), at the request of this Committee, has prepared an analysis of the President's February budget. Copies of that analysis have been distributed to the Members of the Committee and my statement this morning will summarize its findings. I will cover briefly four major topics:

- The prospect of large and growing budget deficits under existing tax and spending policies, even after the economy recovers from the current recession;
- The Administration's proposed budgetary program for dealing with this potential chronic deficit problem;
- The results of CBO's technical analysis of the President's 1983 budget; and
- Some major risks that are inherent in the Administration's proposals.

THE BUDGET OUTLOOK UNDER CURRENT POLICIES

The budget deficit for fiscal year 1982 is now expected to exceed $100 billion. The sharp rise from the target of $38 billion set by the Congress in its budget resolutions last year can be attributed largely to the current recession. Although most economic forecasters--including the CBO--expect that the economy will begin to recover this year and move into a period of continued growth, budget projections by both the Administration and the CBO show steadily rising deficits under existing tax laws and current spending policies. This prospect for a growing budget deficit is illustrated in Figure 1, which depicts the CBO baseline budget projections through 1985.

The CBO baseline budget projections have changed 180 degrees from previous projections, which always showed revenues growing faster than outlays and the budget moving toward a surplus within two or three years. The reason for this change is quite simple. Last year, the Congress enacted the Economic Recovery Tax Act of 1981 which provides for major reductions in individual and corporate income taxes. The effect of the tax act will be to reverse the trend of a growing federal tax burden. Between 1976 and 1981, federal revenues rose from 18.2 percent of the gross national product (GNP) to 21.0 percent of Gross National Product (GNP). Under current tax law, both the Administration and the CBO project a decline in revenues relative to GNP to under 19 percent by 1985.

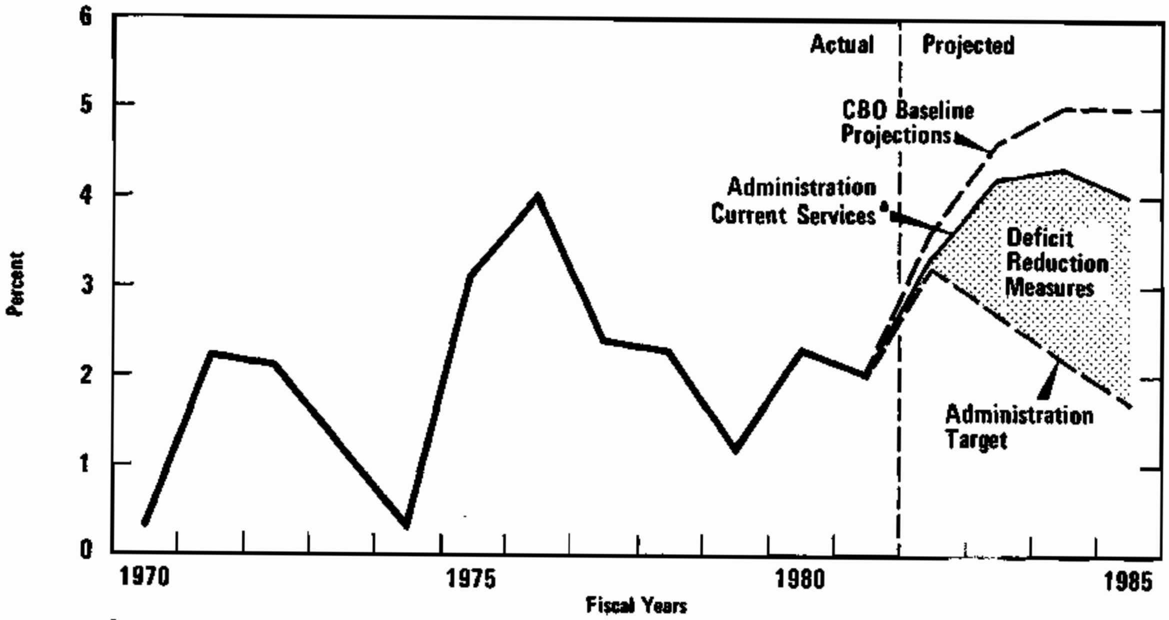
The price of this reduction in the tax burden, however, is a widening gap between revenues and outlays. Figure 1 illustrates that revenues under prior tax law would have been sufficient virtually to eliminate the projected deficits by 1985. Under current law, however, the deficits are projected almost to double during the next three years, rising from about $110 billion in 1982 to $208 billion in 1985.

THE ADMINISTRATION'S BUDGET PROPOSALS

The President's 1983 budget includes a package of proposals designed to reduce the federal deficit gradually over the next few years. If these proposals are adopted, the Administration projects that the deficit would decline from about $100 billion in 1982 to $72 billion in 1985. Relative to GNP, however, the reduction in the deficit would be much larger, as shown in Figure 2. The Administration estimates that its deficit reduction measures would reduce the relative size of the deficit from 3.2 percent of GNP in 1982 to 1.7 percent in 1985. In the absence of these or other policy changes, the deficit would widen to as much as 4 or 5 percent of GNP.

The Administration's budget and proposed deficit reduction measures continue the policies that the Administration recommended, and that were in large part enacted, last year. Defense appropriations would grow rapidly in real terms. The major individual income tax reductions scheduled for this year and next would be left unchanged. Revenues would be only modestly increased relative to baseline levels, primarily through the elimination of tax provisions benefiting a few specific industries and through improved collection of existing taxes.

Figure 2.
Federal Budget Deficit as a Percentage of GNP

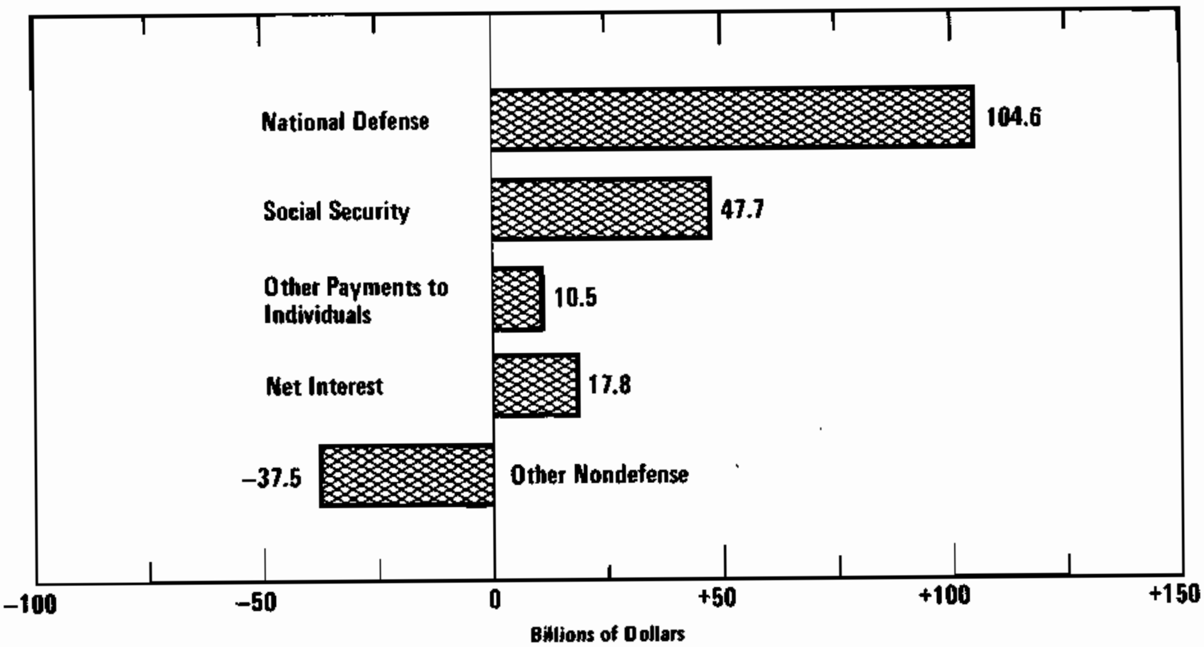


[a] Includes Administration defense spending proposals.

SOURCES: *Budget of the United States Government, Fiscal Year 1983,* p. 3-8, and Table 21, p. 9-60; Congressional Budget Office, *Baseline Budget Projections for Fiscal Years 1983-1987* (February 1982).

Because no major revisions are proposed to the upward path of defense spending or in the personal tax cuts, the planned reduction in the deficit would be achieved primarily through a reduction in spending. The Administration estimates that its deficit reduction measures total about $240 billion over the 1983-1985 period, of which $188 billion--or close to 80 percent--would consist of reduced spending from projected current services levels. The proposed spending reductions do not touch Social Security cash benefits, the largest single nondefense spending program. Interest costs on the national debt depend on the level of debt outstanding and on market interest rates and cannot be directly affected by policy changes. As a result, the proposed spending reductions would cut deeply into federal grants to state and local governments and into spending on the day-to-day domestic operations of the federal government. This is portrayed graphically in Figure 3, which shows the major changes in outlays between 1982 and 1985.

Figure 3.
Proposed Change in Outlays Between 1982 and 1985



SOURCE: *Budget of the United States Government, Fiscal Year 1983,* p. 3-21.

Under the Administration's proposals, defense spending would rise by over $100 billion--from $188 billion in 1982 to $292 billion in 1985--an average rate of increase of about 16 percent a year. Outlays for Social Security benefits would increase by $48 billion, from $155 billion in 1982 to over $200 billion in 1985. Other benefit payments to individuals would fall in 1983 and grow only very slowly in 1984 and 1985, as a result of benefit cutbacks proposed by the Administration.

Net interest costs would continue to rise, although not as rapidly as in the recent past. The remainder of nondefense spending, particularly grants to state and local governments, would bear the brunt of the Administration's budget reduction measures. Over the 1982-1985 period, this category of outlays would fall by more than a third in current dollars and by almost a half in real terms.

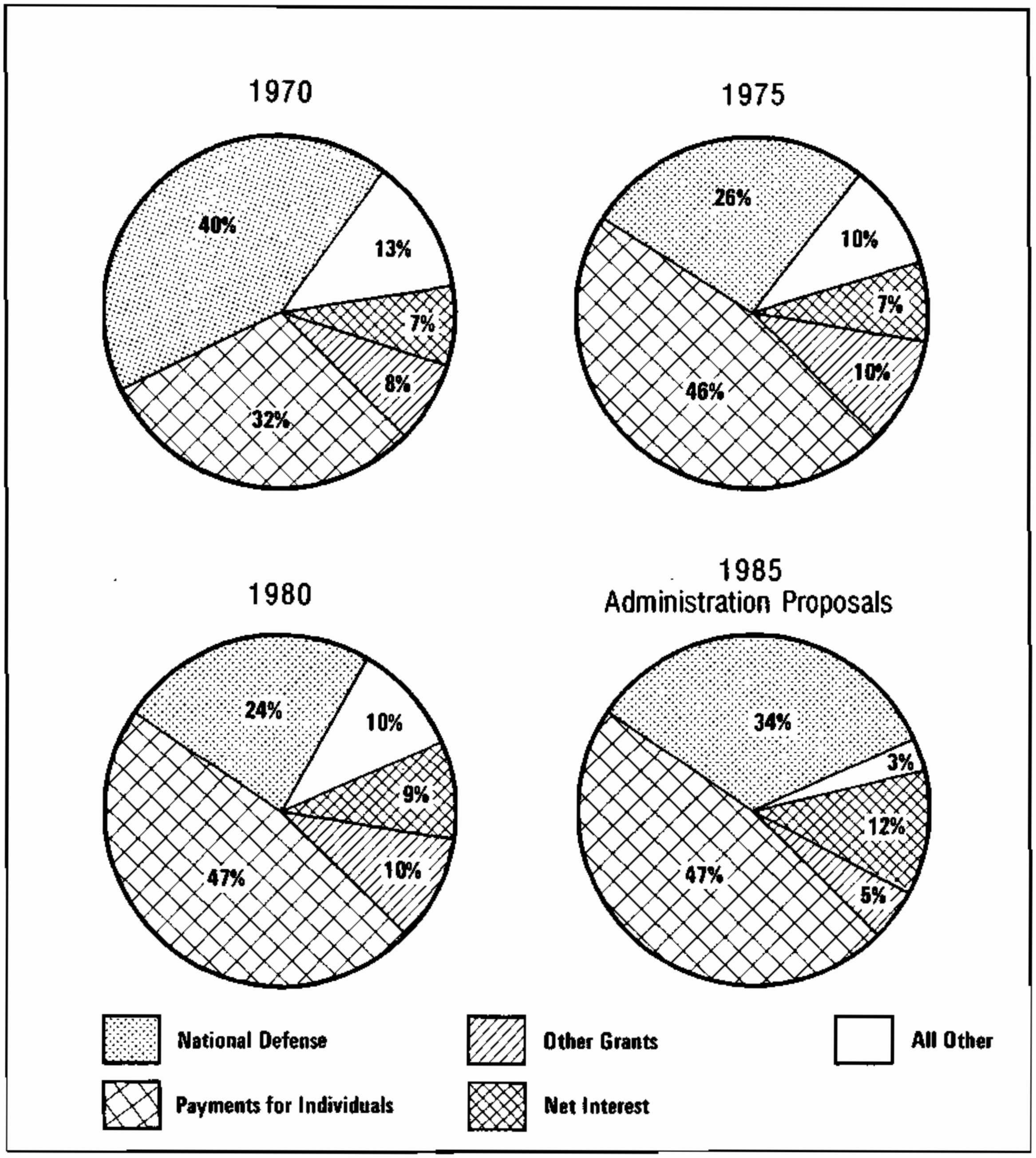
As a result of these proposed changes in outlays, the composition of federal spending would be changed sharply, as illustrated in Figure 4. By 1985, defense spending would represent 34 percent of the budget--an increase from its 1975 and 1980 levels of about 25 percent, but less than the 1970 level of 40 percent. The share of the budget devoted to Social Security and other benefit payments for individuals, which grew from 32 percent of total outlays in 1970 to 46 percent in 1975, would remain roughly constant at about 47 percent. Net interest costs would grow from 9 percent of the budget in 1980 to 12 percent in 1985. The remainder of the budget, which accounted for about 20 percent of total outlays from 1970 to 1980, would shrink to 8 percent by 1985.

CBO ANALYSIS OF THE PRESIDENT'S BUDGET

The Congressional Budget Office's analysis of the President's February budget, finds that revenues would be slightly lower than estimated by the Administration for 1983-1985 and budget outlays would be higher. This finding results from CBO's technical analysis of the Administration's budget estimates and a substitution of CBO's economic assumptions for the Administration's.

Figure 4.

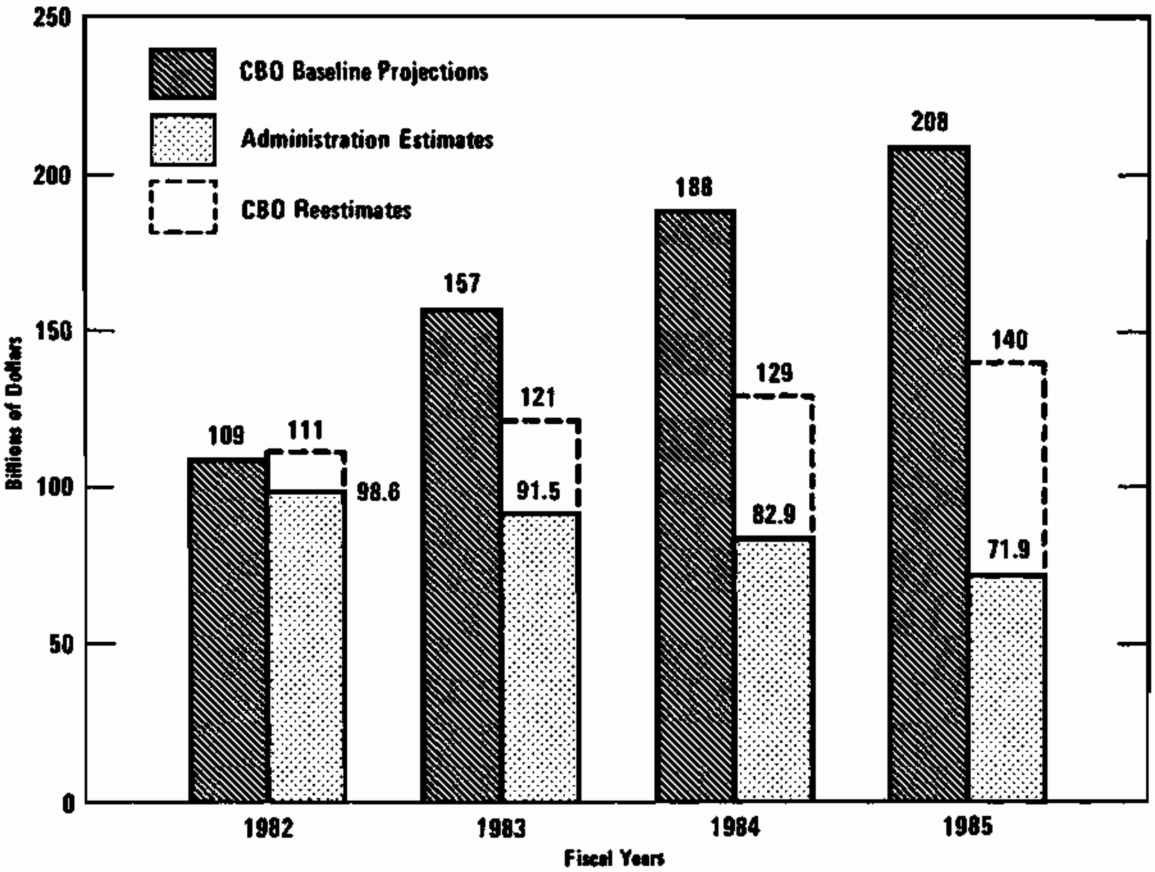
The Composition of Federal Spending



SOURCE: *Budget of the United States Government, Fiscal Year 1983,* Table 22, p. 9-61.

These reestimates produce a dramatic change in the outlook for the budget deficit under the Administration's policy proposals. Instead of declining at a moderate rate, CBO's technical and economic reestimates suggest that the deficit would rise steadily from $111 billion in 1982 to almost $140 billion in 1985--almost twice the level projected by the Administration. This result is shown in Figure 5.

Budget Deficits



Over the three-year period, 1983 to 1985, CBO estimates that the President's budgetary proposals would result in budget deficits that exceed the

Administration's estimates by more than $140 billion. Almost $100 billion, or about 70 percent, of these higher deficits results from technical estimating differences. The CBO technical reestimates for revenues amount to $34 billion and result mainly from different estimates of the revenue effects of the 1981 tax act.

On the outlay side, CBO's technical reestimates add an average of more than $20 billion to the Administration's budget estimates during 1983-1985. The major reestimates involve the cost of farm price supports, which have escalated rapidly in the last few months; the rate of spending for defense procurement activities; likely receipts to be derived from the Administration's plan to accelerate leasing of Outer Continental Shelf (OCS) lands; and net interest costs.

The CBO technical reestimate for farm price supports is based on more recent information about the outlook for farm production and commodity prices than was available for the Administration's budget estimates. The outlook has changed greatly in the last two months, resulting in a substantial increase in the demand for government crop loans. CBO estimates that the effect of bumper crops and lower prices will be to increase net outlays for farm price supports by over $5 billion in both 1982 and 1983, and by another $5 billion spread over the next two years.

The CBO continues to expect spending for defense procurement to proceed at a somewhat faster pace than the Administration, especially spending from funds already appropriated. The CBO bases its judgment on analyses of historical spending patterns and careful monitoring of emerging trends. Last year, CBO's outlay estimates for procurement proved to be more accurate than the Administration's, and spending to date has been consistent with our 1982 estimates.

Estimating receipts to be derived from the sale of OCS leases is very uncertain. Actual bonus receipts derived from individual sales vary widely from expected levels. Nevertheless, the Administration's estimates of OCS receipts totaling--$18 billion a year for the next three years--appears to be overly optimistic. Based on past experience with this program, discussions with industry experts, and the outlook for world oil prices, the CBO estimates that OCS receipts derived from an accelerated schedule will be on the order of $13 billion in 1983 and 1984, and $15 billion in 1985.

The technical reestimate for net interest largely reflects the cost of servicing the higher deficit levels that would result from using CBO's technical reestimates for both revenues and outlays. The increased interest cost of these higher deficits rises from $2.8 billion in 1983 to almost $10 billion in 1985.

Another $44 billion of higher projected deficits during 1983-1985 results from using CBO's baseline economic assumptions instead of the Administration's. These higher deficits result almost entirely from higher outlays; there would be little change in revenues under CBO's economic assumptions from those projected by the Administration.

Economic Assumptions

The economic forecasts of both the Administration and the CBO are in close agreement for 1982. Real GNP is projected to rise by about 3 percent over the calendar year, and the unemployment rate is expected to be in the neighborhood of 8½ percent at year's end. The forecasts of inflation and short-term interest rates are also similar.

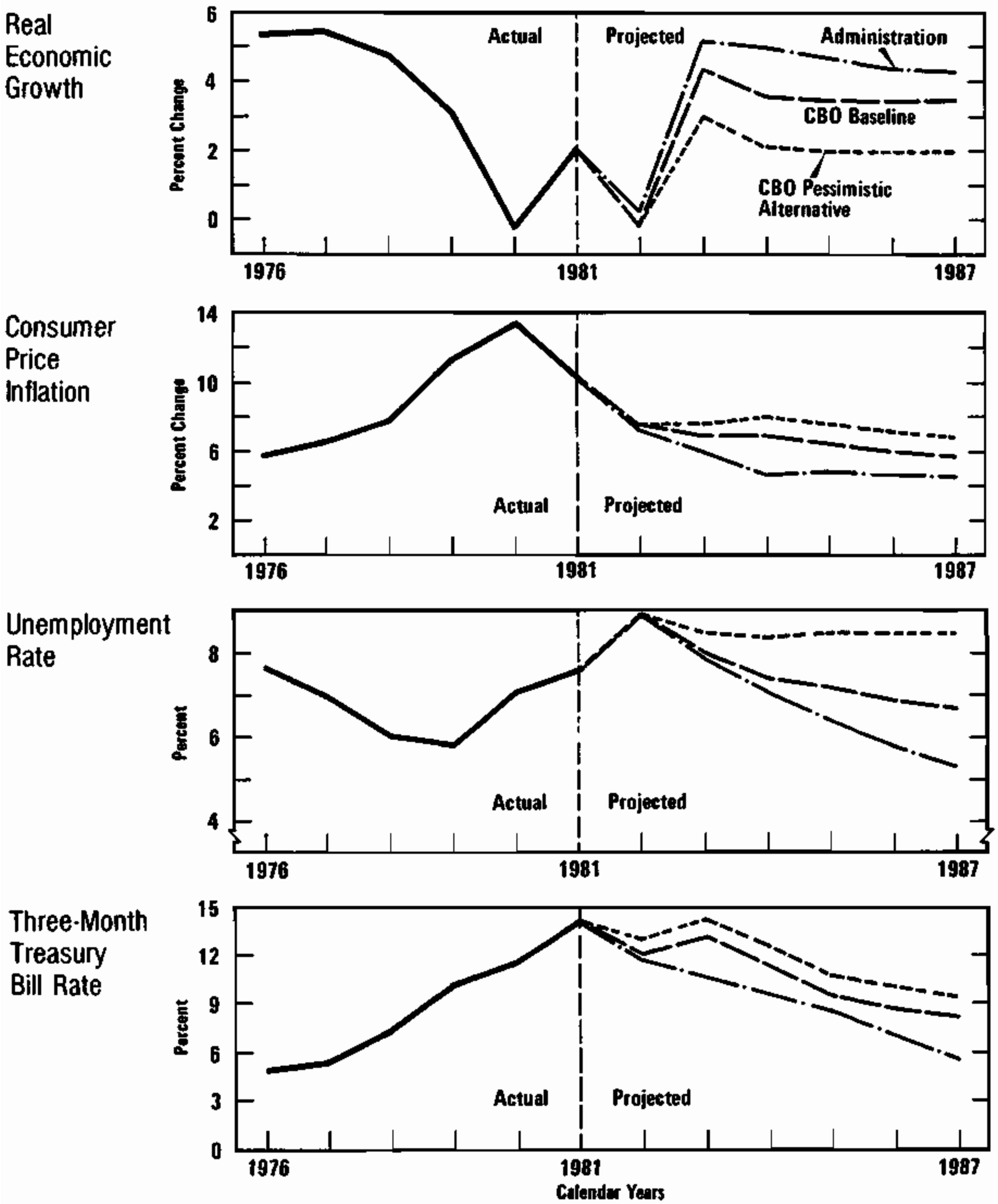
In 1983, however, the Administration's forecast for inflation and real growth is more optimistic than CBO's. While both forecasts imply virtually the same expansion of nominal GNP, the Administration looks for real GNP to grow by 5.2 percent over the four quarters of 1983, and for inflation (as measured by the GNP deflator) to fall to a rate of 5.5 percent. The CBO, in contrast, expects real GNP to grow by about 1½ percentage points less than the Administration does in 1983, and the GNP deflator to rise by about 1½ percentage points more. The slower growth expected by the CBO results largely from the higher interest rates in its forecast, which would dampen the recovery in economic activity.

The Administration's economic assumptions for 1984 and beyond are also more optimistic than the CBO's, as may be seen in Figure 6. Compared with the CBO baseline assumptions, the Administration projects higher real growth and greater declines in inflation, unemployment, and interest rates.

The Administration's real growth assumptions for 1984-1987 are near the upper end of historical experience. In comparable four-year periods following previous postwar recoveries, real economic growth averaged 3.4 percent a year and ranged between 2.0 and 5.2 percent a year. The Administration assumes an average growth rate of 4.6 percent a year between 1984 and 1987. The CBO, in its baseline projections, assumes an average annual growth rate of 3.5 percent.

Figure 6.

Comparison of Major Economic Assumptions



SOURCES: For historical data, Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; and Federal Reserve System, Board of Governors. For projections, Congressional Budget Office and Office of Management and Budget.

SOME MAJOR RISKS

Several risks are inherent in the Administration's budget proposals. One is that the Administration may have underpriced its projected defense appropriation requests. CBO has identified two major elements of concern in this regard. First, inflation may not decline as rapidly as assumed for the Administration's budget estimates. With higher than anticipated inflation, the Administration would either have to scale back its planned defense purchases to stay within available funds or seek additional funds to complete the planned purchases. The CBO reestimates of the President's budget did not adjust the Administration's projected budget authority for defense programs for the higher inflation contained in the CBO baseline economic assumptions--that is, the CBO did not assume that the Administration would hold to its purchase plans. If this were done, $61 billion in additional appropriations would be needed during the next five years to achieve the Administration's real growth proposals.

Second, the real cost of defense purchases has grown in recent years--averaging about 3½ percent per year since 1975. This has occurred for a variety of reasons, including program changes (such as new specifications for weapons or revised production schedules) and underestimates of real resources (such as manufacturing hours and materials costs). If the Administration is unable to curb this cost growth, further funds would be needed to meet its defense procurement objectives. If the 3½ percent average annual cost growth continues, for example, CBO estimates that an additional $48 billion in new budget authority would be required to fund major weapons procurement during 1983-1987.

A second risk is that the Administration may not be successful in meeting all of its targets for revenue increases and outlay savings from various management initiatives. CBO has not been able to develop its own independent estimates for outlay savings from several of these initiatives, particularly those that are clearly targets and are not allocated to specific budget accounts. The unallocated targets for reduction of waste, fraud, and abuse; for improved debt collection; and for the sale of surplus or underused federal property total $16 billion over the 1983-1985 period. Based on past history, these targets are very optimistic.

A more fundamental risk is the uncertainty in the economic outlook. The Administration's program implies a strong fiscal stimulus in 1982 and 1983. The large budget deficits estimated by the Administration and the even larger deficits projected by the CBO would result in a marked increase in Treasury borrowing that would put further upward pressure on interest rates. At the same time, the Federal Reserve's targets for monetary growth may act as a brake on economic growth during the next few years.

Given the combination of monetary and fiscal policies and the projected economic recovery, high interest rates next year seem likely--although the level is hard to predict because this policy combination of a tight monetary policy and a stimulative fiscal policy is virtually without precedent. Nevertheless, there is a significant risk that the outcome could be weaker growth than projected by either the Administration or the CBO.

Since budget estimates are very sensitive to economic assumptions, policymakers must be prepared for the possibility of developments markedly different from those assumed by both the Administration and the CBO. To illustrate the sensitivity of the budget to economic assumptions, the CBO has also reestimated the President's February budget using a more pessimistic set of economic assumptions. The CBO pessimistic assumptions are portrayed in Figure 6. In these assumptions, real growth averages only 2.0 percent in 1984-1987, unemployment remains above 7 percent until the end of the period, and short-term interest rates fall very slow.

Under this more pessimistic set of assumptions, growth in nominal incomes would be somewhat less and federal revenues would be lower by about $20 billion during 1983-1985 than projected by the Administration. The effect on outlays, however, would be much greater. By 1985, outlays would be over $50 billion higher than projected by the Administration, and for the entire three-year period they would be more than $100 billion higher. The effect of using the CBO pessimistic economic assumptions together with CBO's technical reestimates would be to raise the estimated deficit levels under the Administration's proposals to $132 billion in 1983, $155 billion in 1984, and $184 billion in 1985.

CONCLUSION

This is a very grim outlook for the budget. If the prospective rise in the federal budget deficit were exclusively, or principally, a temporary cyclical phenomenon, there would be little cause for concern. Indeed, rising budget deficits during periods of recession serve to limit both the magnitude and the duration of the decline in economic activity. Once recovery is underway, the recession-induced bulge in the deficit disappears as tax revenues grow and as outlays for unemployment compensation and related programs decline.

Unfortunately, the budget problem facing the U.S. Congress is not recession-related. It is, rather, a problem of continuing large and growing federal deficits into the foreseeable future. The problem of chronic budget deficits is not new, as evidenced by the fact that the federal budget has been in deficit for 19 out of the last 20 years. However, the difficult economic and budget issues raised by these earlier deficits pale by comparison with the problems that face the country today. No clear economic rationale exists for the persistence of deficit spending year after year, and the distinct possibility exists that large and rising budget deficits could seriously impair the overall performance of the economy over the longer run.

To reduce the risk of continued economic instability, both in the near term and in the longer run, the Congress may wish to consider possible alternatives to the President's budgetary proposals. The CBO has laid out a series of possible strategies and options for reducing the federal deficit in Part III of our annual report to the Budget Committees--Reducing the Federal Deficit: Strategies and Options.