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Mr. Chairman, in my testimony today I will discuss the economic and budgetary implications of H. J. Res. 350, the Balanced Budget Amendment to the Constitution. The popularity of this proposal has served a positive and most important function: it has increased public awareness of the size of the federal deficit, of the need to act decisively on controlling federal spending, and of the desirability of reexamining all the potential sources of federal revenue. The proposal does, however, raise a host of issues.

The scope of this testimony is limited primarily to the problems of implementation if the amendment forced a balanced budget in the next few years. I will cover three points:

- Most important, because we are starting from a position of substantial prospective budget deficits, the amount of reduced outlays or increased taxes called for by the amendment could endanger the economic recovery and create widespread dislocations if the amendment is implemented at an early date.
- In the long run, the Congress would lose flexibility in setting fiscal policy. While that would be tolerable for moderate swings in the economy, it could become more problematic in a prolonged or severe slump.
- Implementation of the amendment would require significant revisions in the budget process.

IMPACT ON THE BUDGET AND THE ECONOMY

Last year's tax act and spending decisions, coupled with declining inflation and the recession, brought about the budget outlook facing the Administration and Congressional negotiators this past spring. The April baseline budget projections, which generally assume a continuation of policy, showed that, even assuming a moderate economic recovery for fiscal years 1983 to 1985, the projected budget deficits would be large and would increase from year to year (see Table 1). (The deficit totals in Table 1 include the outlays of off-budget entities because the proposed amendment requires that they be counted.) By 1985, the total deficit was projected to exceed $250 billion, or 5 percent of gross national product (GNP). Virtually no economic theory could support a governmental financial structure that showed such high deficits as the economy progressed to a more prosperous state.

As a consequence, the First Concurrent Resolution that passed in June instructed the committees of both Houses to bring forward legislation to raise taxes and lower spending over the period spanning fiscal years 1983-1985. Projections of the budget under the assumptions of the First Concurrent Resolution show a substantial reduction in deficits and the elimination of the widening pattern over time.

TABLE 1. PROJECTED FEDERAL DEFICITS (By fiscal year, in billions of dollars)

	1983	1984	1985
April Baseline Projections			
Unified Budget Deficit	182	216	233
Off-Budget Spending	21	21	20
Total Deficit	203	237	253
First Concurrent Resolution on the Budget for 1983			
Unified Budget Deficit	104	84	60
Off-Budget Spending	21	21	20
Total Deficit	125	105	80
Budget Resolution with Preliminary CBO Reestimates			
Unified Budget Deficit	141-151	145-160	143-158
Off-Budget Spending	21	21	20
Total Deficit	162-172	166-181	163-178

Unfortunately, the economy almost never behaves exactly as the budget resolution assumes, and this year is no exception. The recent CBO preliminary forecasts show that, when the budget estimates are revised to take into account the severity of the current recession (together with small downward revisions in projections of real economic growth and inflation), deficits by 1985 could swell to \$143 - \$158 billion on a unified budget basis and to \$163-\$178 billion including the off-budget deficits. This reestimate does not mean that the budget-tightening actions contemplated by the First Concurrent Resolution are futile, but it does indicate that attaining budget balance by the mid-1980s will be much more difficult than previously thought.

If H. J. Res. 350 were ratified by the states before October 1983, its provisions would become effective for fiscal year 1985. This would mean that revenues in 1985 could not exceed an amount derived by applying the growth rate in national income for calendar year 1983 to fiscal year 1984 revenues (unless a specific bill providing for greater revenues was passed by a majority of the whole membership of both Houses). The revenue ceiling would also become the limit on total outlays--including outlays of off-budget entities--under the provision forbidding a planned deficit.

The budgetary and economic implications of these provisions would be severe. The amendment would leave the Congress with two alternatives in the next two years:

- o To cut spending abruptly below the level projected in the First Concurrent Resolution; and/or
- o To raise taxes sharply above the amounts projected in the First Concurrent Resolution.

If the Congress failed to take either action, it would be forced to waive the provisions of the amendment in its first year of implementation. This could be done only by a three-fifths vote of the whole membership of both Houses.

Specifically, if CBO's current forecast is accurate, the amendment would require additional spending cuts and tax increases (over and above the cuts and tax increases in this year's budget resolution) that together would add up to $163-$178 billion, or about 4 percent of GNP. That is what budget balance could mean in cold numbers.

Impact on the Economy

The effect on the economy of such a shift in taxing and spending in fiscal year 1985 could be severe. The initial reduction in incomes of taxpayers, or of entitlement recipients, or of firms selling goods and services to the government would set off a chain of declining purchases, reductions in output, and job-cutting. This shock would come at a time of 8 percent unemployment, according to our preliminary forecast. If the Congress tried to anticipate the problem by partially implementing the tax increases and spending cuts in 1984, the changes would begin at a time when the recovery was even younger and the unemployment rate was even higher.

The effects of such a huge reduction in fiscal stimulus on real growth and unemployment could be offset only if real interest rates were to fall sharply and if interest-sensitive sectors were to rebound rapidly. The problem with this scenario for the near future is that our projections of the budget already assume a very substantial decline in real interest rates. For example, the three-month Treasury bill rate corrected for underlying inflation averaged about 6½ percent in the first half of this year. We now expect it to decline to about half that by 1985. A sharp reduction in fiscal stimulus in 1984 and 1985 would put very heavy pressure on the Federal Reserve to bring interest rates down even more, but there might be limits on its ability to respond. Even if real interest rates did come down, $170 billion in reduced fiscal stimulus would have to be replaced by increased economic activity in the consumer durable, housing, and plant and equipment sectors. While it is not impossible for these sectors to expand so rapidly, the pace of the expansion that would be needed to fill the gap seems overly optimistic.

In short, implementation of the First Concurrent Resolution already implies significant progress toward correcting the unhealthy budget outlook projected earlier this year. One may hope that these budget actions will bring down real interest rates and strengthen the expected economic recovery. Further action along these lines will probably be necessary. But it is extremely unlikely that a reduction in fiscal stimulus sufficient to balance the budget as early as 1984 and 1985 would be consistent with continued economic recovery.

Impact on Government Programs

Cutting an additional $170 billion from the fiscal year 1985 deficit would be a very difficult task. If a large part of it was done on the spending side of the budget, major dislocations in existing programs would result. Table 2 shows that by 1985 national defense spending will be nearly one-third of the budget outlays, net interest will be 13 percent, and entitlement programs will be 47 percent (nearly half accounted for by Social Security), under the assumptions of the First Budget Resolution. If spending cuts were concentrated in the remaining portion of the budget, it would be wiped out. This can be seen in the table which shows that the outlays for "other non-defense" and for off-budget entities are projected to total about $97 billion in 1985. "Other non-defense" is made up of grants to state and local governments, farm price supports, research, pay in civilian agencies, and the like, and is the portion of the budget already hardest hit by the budget resolutions of the last two years. Budget cuts of the magnitude implied by the application of the Balanced Budget Amendment would have to be made in large part in the national defense

TABLE 2. COMPOSITION OF OUTLAYS (By fiscal year)

	Actual 1981	Projection 1985 a/
	In Billions of Dollars	
National Defense	160	281
Social Security	138	195
Other Payments to Individuals	179	236
Net Interest	69	122
Other Nondefense	112	77
Unified Budget Outlays	657	911
Off-Budget Federal Entities	21	20
Total Outlays	678	931
	Percent Share of Unified Budget	
National Defense	24	31
Social Security	21	21
Other Payments to Individuals	27	26
Net Interest	11	13
Other Nondefense	17	8
Unified Budget Outlays	100	100

Note: Detail may not add to totals because of rounding.

a/ First Concurrent Resolution on the Budget for Fiscal Year 1983 with preliminary CBO reestimates.

and entitlement sectors. While I believe that more careful scrutiny of these areas of the budget is long overdue, I do not think that a target of cutting $170 billion, or even half of that, within two years would be realistic. It would result in lost benefits to current beneficiaries, elimination of all cost-of-living adjustments, and triggering of penalty payments to government contractors. Abrupt huge cuts in grants to states would prompt emergency state tax hikes, and blunt caps on entitlements would have unintended consequences and would have to be reversed later. Some of these effects have already resulted from past budget cuts; moving too swiftly in the future would cause even more dislocations.

A similar case could be made against moving too abruptly in raising taxes to balance the budget. Almost all tax bills have phased in tax changes over a period of years to avoid suddenly disrupting business and consumer plans.

LONG-RUN EFFECTS OF H. J. RES. 350

I have stressed in this testimony the potential effects of implementing the Balanced Budget Amendment in the next few years, before the economy and the budget have had a chance to get back to equilibrium. Over time, if a balanced budget rule is implemented more gradually and with a smaller underlying deficit, it would be less troublesome. However, even in equilibrium a balanced budget rule could be problematic. H. J. Res. 350 does not rule out all budget deficits. Specifically, it allows a deficit that comes about when a recession lowers receipts. Also it permits an increase in receipts when inflation drives taxes above planned amounts. In this way, the amendment would preserve the most important parts of our automatic fiscal stabilizer, which helps to conteract moderate swings in the economy. The amendment does, however, set up barriers to the active use of federal spending to fight unemployment and to the freedom of the Congress to plan a large tax cut in the absence of a planned reduction of expenditures. For moderate business fluctuations, this loss of flexibility in fiscal policy might not be so bad. I would envision that the loss might be offset by pressure for a more active monetary and credit policy to serve as a balance wheel, and they could probably do so effectively. However, if a deep or prolonged contraction in the economy came about after H. J. Res. 350 was in place, leaving the responsibility for economic recovery solely to the monetary and credit authorities would probably impose a bigger burden on them than they could handle. No doubt, under such depressed conditions, a 60 percent vote of both Houses could probably be mustered and a tax cut or spending boost would be passed.

Another possible difficulty with H. J. Res. 350 is that its requirement that actual outlays not run above budgeted outlays could imply perverse fiscal behavior under certain circumstances. For example, if an unanticipated recession drove up unemployment payments, and thereby caused an outlay overrun, the amendment would require the Congress to make offsetting budget cuts. Such cuts would deepen the recession. On the other hand, if spending in some parts of the budget ran over because of an unexpected surge of inflation, the strictures in the Balanced Budget Amendment would dictate helpful offsetting changes in total spending.

THE BUDGET PROCESS UNDER THE AMENDMENT

Several problems for budget procedures are raised by H. J. Res. 350. The proposed amendment calls for "the Congress and the President to ensure that actual outlays do not exceed" budgeted outlays. Currently, the budget process does not directly control outlays. Outlay estimates are made for all pertinent legislation, but the Congressional process is enforced by prohibitions on enactment of laws. The distinction is that, if a forecast error is made and outlays rise above budget, currently nothing need be done. Under the constitutional amendment, something would have to be done to hold down the actual outlay total. Either the Executive Branch would have to be delegated that power or, as I understand Senator Domenici's amendment that was accepted in the Senate, legislative procedures would have to be designed to control outlays directly. I am not sure what legislative procedures are possible, but I do know that we would need them quickly because our ability to forecast outlays with precision is very limited. Outlays can rise because economic growth is lower than expected, because interest rates rise unexpectedly, because more people retire than anticipated, or because inflation turns up from some uncontrollable factors. Legislation to implement the amendment's requirement would have to specify responsibilities for monitoring outlays, rules as to how frequently they must be reestimated, and mechanisms for the Congress to communicate changes to the Executive Branch, which spends the money. This could turn out to be more difficult than it appears.

Second, I am sure that this committee is concerned with what would happen if we were to come up to the start of the fiscal year with the Congress having failed to adopt the constitutionally required budget statement. A budget impasse would sorely test federal-state relations and business-like conduct of federal agencies. This could probably be handled by legislation and procedures, but they would have to be put in place quite soon.

Finally, if H. J. Res. 350 were passed, methods of integrating it with several budget process innovations that are working their way through the Congress should receive some attention. In particular, several biennial budget plans (with two-year fiscal periods) are under consideration, as are proposals for integrating tax expenditures and credit into the process and for undertaking a capital and operating budget. These are not necessarily incompatible with a Balanced Budget Amendment, but their interaction deserves thorough planning.

CONCLUDING REMARKS

As I indicated earlier, the most serious economic and budget problems that would potentially flow from enactment of H. J. Res. 350 would derive from its possible speedy implementation in an economy with high unemployment and high deficits. If we could set a less ambitious but attainable goal (say, a deficit no greater than 1 percent of GNP in four years), the economic risks would be reduced. Having attained that objective, the next step of reaching a balanced budget would be less jolting to the economy. Implementing a permanent budget role at that stage would still pose the potential problems of lost policy flexibility and perverse spending requirements.

The government's primary budget problem for the next five years--with or without this amendment--is how to set out and stick with a plan for sure and steady progress toward a sounder federal budget. In this connection, solidifying the gains already made in strengthening the budget process should be a high priority. I hope that, whatever the outcome of this legislative debate, the message of a continuing need to strengthen budget discipline will not be lost.