Statement of
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Mr. Chairman, I am pleased to have the opportunity to testify on the economic and budgetary outlook. As you know, economic conditions have improved greatly since the end of last year. The economic recovery is proceeding at a rapid pace, about in line with past recoveries. Unemployment has already declined substantially, though it remains high. Inflation was greatly reduced during the recession and, while it has not declined further in recent months, the recovery has not generated any significant acceleration in the rate of price increases. The near-term economic outlook also looks favorable. Although economic growth is not likely to proceed at the brisk pace of the last two quarters, most forecasters expect it to be substantial.

The horizon is clouded, however, by large federal deficits, which have not yet been dealt with decisively. The first budget resolution for fiscal year 1984 took an important step toward reducing future deficits, but the resolution has not yet been fully implemented. Consequently, many fear that deficits will not decline significantly as the recovery proceeds.

In a report issued last August entitled The Economic and Budget Outlook: An Update, the Congressional Budget Office (CBO) provided the Congress with revised economic and budget estimates based upon the policies of the first resolution. My testimony today will summarize and update that report and comment on the risk that may arise if the Congress and the Administration fail to implement the policies of the resolution.

Recent Economic Developments

While the combined effects of the 1980 and 1981-1982 recessions led to the highest unemployment rate in the post-World War II period, the recovery has since been vigorous. Real gross national product (GNP) increased at an average annual rate of 8.7 percent in the last half year, and industrial production increased at a 20 percent annual rate (see Table 1). As a result, the civilian unemployment rate, which was 10.8 percent last December, had declined sharply to 8.4 percent by November. In terms of aggregate growth, the recovery now appears to be proceeding at a rate near the average of other postwar recoveries (see Figure 1 at the end of this statement). At the same time, inflation rates remain very moderate relative to the high rates of the past several years. In the last half year, the GNP fixed-weight deflator, a broad measure of price behavior, has increased at about a 4 percent rate, only slightly higher than the low point in inflation last winter. While inflation certainly has not been cured, the improvement since 1980 and 1981 has been dramatic. Productivity growth, while not quite as high as typical for a recovery period, has also been encouraging after a decade of very poor productivity performance.

In one respect, however, this business cycle is not typical. As shown in Figure 3, interest rates remained at remarkably high levels in the recession and continue so in the recovery. Interest rates also appear to have remained high in real terms (that is, adjusted for inflation). Most analysts believe that the very large increase in the actual and projected deficits has

TABLE 1. RECENT ECONOMIC INDICATORS (Percent change from previous period at seasonally adjusted annual rates, unless otherwise noted)

			1982		1983		
	1981	1982	Q3	Q4	Q1	Q2	Q3
Real GNP	2.6	-1.9	-1.0	-1.3	2.6	9.7	7.7
Final sales	1.8	-0.7	-1.5	4.5	0.6	6.8	5.1
Consumption	2.7	1.4	0.9	3.6	2.9	10.0	3.0
Business fixed investment	5.2	-4.7	-8.8	-6.6	-1.5	7.9	16.3
Residential investment	-5.2	-15.4	-13.0	53.2	57.3	79.5	30.1
Government purchases	0.8	1.8	9.4	10.6	-8.8	-1.1	5.3
Inventory Change (billions of 1972 dollars)	8.5	-9.4	-1.3	-22.7	-15.4	-5.4	3.9
Net Exports (billions of 1972 dollars)	43.0	28.9	24.0	23.0	20.5	12.3	10.4
Industrial Production	2.6	-8.2	-3.4	-8.4	9.9	18.4	21.5
Payroll Employment (millions)	91.2	89.6	89.3	88.8	88.8	89.5	90.2
Civilian Unemployment Rate (percent)	7.6	9.7	10.0	10.7	10.3	10.1	9.4
Inflation Rate							
CPI-U	10.3	6.2	7.7	1.9	-0.4	4.3	4.7
GNP deflator (fixed weight)	9.5	6.4	5.9	4.7	3.4	4.3	4.4
Productivity a/	1.9	-0.1	2.3	1.3	3.7	6.6	3.1
Interest Rates (percent)							
Treasury bill rate	14.0	10.6	9.3	7.9	8.1	8.4	9.1
Corporate AAA bond rate	14.2	13.8	13.8	11.9	11.8	11.6	12.3

a/ Output per worker hour, nonfarm business sector.

contributed to the high rates. The federal deficit was about 108 percent of net private saving during fiscal year 1983, a record for the postwar period. Of course, deficits increase automatically in recessions and this is thought to retard the fall in economic activity. But in 1983 there was a sharp rise in the structural deficit—that is, the deficit that would be experienced at high levels of employment. (Putting this in technical terms, the standardized employment deficit rose from 0.9 percent to 2.8 percent of potential GNP.) It is this increase in the structural deficit that is worrisome.

Attempting an explanation of the evolution of economic activity this early in the recovery is somewhat risky. Certain patterns are emerging, however, and they may give us some insights into the "crowding-out" effects of high interest rates resulting from unusually high deficits.

Thus far, business fixed capital formation is following a normal cyclical pattern and does not seem to be adversely affected by the high level of interest rates (see Figure 4). This might suggest that the negative impact of high real interest rates on investment is being offset by the net favorable effects of the tax acts of 1981 and 1982—the Economic Recovery Tax Act (ERTA) and the Tax Equity and Fiscal Responsibility Act (TEFRA). Housing has also recovered at a normal rate, even though owner-occupied housing received little in additional tax benefits. However, the housing industry started at such a low trough that residential investment still constitutes an unusually low share of GNP for this stage of the business cycle (see Figure 5). In addition, there are growing signs that housing activity may have reached a plateau.

Net exports have declined dramatically (see Figure 6). This implies that a significant portion of the budget deficit is being financed, directly and indirectly, by foreign capital inflows. High real interest rates here and political and economic uncertainties abroad are making the United States a relatively attractive place to invest. Foreigners must acquire dollars to purchase U.S. securities, and in doing so they bid up the exchange value of the dollar. This makes it harder for our export industries to compete abroad and for our domestic industries to compete with imports. In other words, our trading industries are bearing a significant portion of the crowding-out effect of federal deficits.

The CBO Short-Run Forecast

The CBO August forecast, made under the assumption that the first budget resolution would be implemented, shows real GNP growing at a rate of 5.8 percent in the current calendar year (fourth quarter to fourth quarter) and 4.3 percent in 1984 (see Table 2). The civilian unemployment rate is projected to average 9.7 percent in 1983 and 8.4 percent during 1984. Prices, as measured by the GNP deflator, are projected to rise by 4.6 percent this year and by 5.0 percent in 1984. The small increase in inflation next year results from increases in Social Security taxes and an assumed decline in the value of the dollar in international exchange markets, as well as some tightening of labor markets and restoration of profit margins. Treasury bill rates are projected to average about 8.8 percent in 1983 and close to that in 1984.

TABLE 2. THE CBO SHORT-RUN FORECAST

	Actual	Projections	
	1982	1983	1984
Fourth Quarter to Fourth Quarter (percent change)			
Nominal GNP	2.6	10.6	9.5
Real GNP	-1.7	5.8	4.3
GNP Implicit Price Deflator	4.4	4.6	5.0
Calendar Year Average (percent)			
Civilian Unemployment Rate	9.7	9.7	8.4
Three-Month Treasury Bill Rate	10.6	8.8	8.6

The economic information that has become available since this forecast was prepared in early August is consistent with the short-term story told in the forecast. The unemployment rate has declined considerably faster in recent months than expected and we have already attained the average rate expected earlier for 1984, but prices and real GNP, seem likely to be very close to the forecast for 1983. Both consumption and federal spending in the third quarter came in a little lower than CBO had expected, but inventory investment and investment in producers' durable equipment were a little stronger than anticipated. Some interest rates have fallen a little faster than forecast. But the main lines of the economic situation are much as expected in early August.

As usual, a number of uncertainties cloud the short-run outlook. Four risks in particular are noteworthy:

- The interest rates in the CBO forecast were based on the assumption that the deficit-reduction program of the budget resolution would be implemented. However, whether that will actually occur is an open question today and thus higher rates are a real possibility.

- Prices could be more sensitive to economic growth than assumed in the CBO forecast. Also, the prospect of large federal deficits could have more serious effects on inflationary expectations. In addition, the forecast assumes no inflationary shocks, such as another bad harvest, a serious interruption in oil supplies, or a very rapid depreciation of the dollar in foreign exchange markets.

- The debt problems of a number of developing countries seem to have eased at least temporarily, but remain serious. Even a small increase in interest rates, or a further delay in the recovery of the industrial countries, could tip the balance—with serious consequences for U.S. exports.

- A loss of confidence in the dollar because of dismay over U.S. fiscal policy or other factors could significantly raise interest rates and inflation.

Longer-Run Economic Projections

The longer-run economic projections shown in Table 3 were originally prepared for the House Budget Committee staff to show what might happen if productivity rebounded to its historical growth rate. The figures for 1985-1989 are thus not a forecast; rather, they are noncyclical projections that assume the economy moves gradually toward higher employment levels without price shocks. Economic recovery continues at a moderate and gradually slowing pace in the projections. Productivity growth moves close to historical norms, with a trend growth rate approaching 2 percent annually by the end of the period—a rate viewed as optimistic by some economists.

TABLE 3. LONGER-RUN ECONOMIC PROJECTIONS

Economic Variable	1983	1984	1985	1986	1987	1988	1989
GNP (billions of current dollars)	3,313	3,644	3,972	4,307	4,651	5,028	5,425
Real GNP (percent change, year over year)	3.1	5.0	4.0	3.5	3.4	3.4	3.3
GNP Implicit Price Deflator (percent change, year over year)	4.5	4.8	4.8	4.8	4.4	4.6	4.4
Consumer Price Index, CPI-U (percent change, year over year)	3.2	4.7	4.7	4.7	4.5	4.6	4.4
Civilian Unemployment Rate (percent, annual average)	9.7	8.4	7.9	7.5	7.1	6.9	6.6
3-Month Treasury Bill Rate (percent, annual average)	8.8	8.6	7.7	7.4	6.9	6.9	6.7

The unemployment rate declines gradually, to near 6½ percent for 1989. Inflation declines very slowly after 1986, to about a 4½ percent rate by the end of the period. The three-month Treasury bill rate declines to about 6½ percent by the end of the period.

How would this economic growth performance compare with historical experience? One perspective on this question is provided by data on the average annual rate of growth for seven-year periods following the trough quarters of postwar recessions (see Table 4). The projected growth would be about average. (The average for the six postwar recoveries is 4.0 percent, and for the projection is 3.9 percent.) There is a substantial variation in the averages for different periods, however, ranging from near 5 percent in some to near 3 percent in others.

TABLE 4. AVERAGE REAL GNP GROWTH DURING POSTWAR CYCLICAL RECOVERIES (In percents)

Trough Quarter of Recession	Average Growth During Seven Years Following Trough
1949:4	4.7
1954:2	3.1
1958:2	4.6
1961:1	5.0
1970:4	3.6
1975:1	3.1
Average recovery	4.0

The growth implied in this projection may be optimistic. Economic growth has become slower in advanced economies generally, and some economists believe that the conditions that gave rise to the rapid growth in the 1950s and 1960s are no longer present. The heavy debt burdens of some developing countries endanger the short-run forecast, but they are a long-run problem as well. In addition, current U.S. monetary and fiscal policies are unusual and may not be consistent with the projected growth path. Finally, if recovery should threaten to spark renewed inflation, the Federal Reserve might take anti-inflationary steps that could temporarily slow economic growth.

Perhaps the greatest uncertainty is in the interest-rate projection. It was made on the assumption that the Congress would take deficit-reducing measures in the last session. A serious prospect of permanently large deficits would intensify pressures on U.S. capital markets and risk a loss of confidence in the dollar, which could raise interest rates and inflation rates above those in the projections.

Preliminary Baseline Budget Projections

Using the CBO August short-run economic forecast and the longer-run economic assumptions in Table 3, we recently prepared some preliminary baseline budget projections for fiscal years 1985-1989. These projections show that, under current taxing and spending policies, the federal budget deficit will remain around 5 percent of gross national product, or higher, for the foreseeable future.

Table 5 depicts the budget outlook under current taxing and spending policies through fiscal year 1989. Although these preliminary baseline projections do not reflect all of the Congressional actions taken in the last session, subsequent developments have not changed the situation substantially. On the one hand, cuts in Medicare and delays in cost-of-living adjustments for federal retirees were not enacted in a reconciliation bill, but on the other hand, appropriations for both defense and nondefense discretionary spending were less than assumed in the first budget resolution. Also, the slowdown in spending that occurred in 1983 is expected to continue to hold down outlays in 1984. As of today, we estimate that 1984 outlays will total about $850 billion and that the unified budget deficit will be about $185 billion with an additional $15 billion of off-budget financing.

Our baseline projections for 1985-1989 assume no changes in current laws governing taxes and entitlements and other mandatory spending. The outlay projections for national defense assume 5 percent real growth in annual appropriations, as contained in the first budget resolution, and zero real growth for nondefense discretionary appropriations.

Under our preliminary baseline assumptions, both revenues and outlays keep pace with projected GNP growth. Revenues as a share of GNP remain slightly under 19 percent, and outlays hover around 24 percent. As a result, the budget deficit remains at about 5 percent of GNP through 1989.

TABLE 5. PRELIMINARY BASELINE BUDGET PROJECTIONS (By fiscal year)

	1983 Actual	1984 Est.	CBO Projections 1985	1986	1987	1988	1989
			In Billions of Dollars				
Revenues	601	665	733	796	857	928	998
Outlays	796	850	925	993	1,084	1,177	1,278
Deficit	195	185	192	197	227	249	280
			As a Percent of GNP				
Revenues	18.6	18.7	18.8	18.9	18.8	18.8	18.7
Outlays	24.6	23.9	23.8	23.5	23.8	23.9	24.0
Deficit	6.0	5.2	4.9	4.7	5.0	5.1	5.3
Reference:GNP ($billions)	3,230	3,562	3,890	4,222	4,563	4,930	5,325

The composition of spending, however, is likely to change substantially over the next five years. In our preliminary projections, domestic spending (entitlements and nondefense discretionary spending combined) declines from 15.2 percent of GNP in 1984 to 13.9 percent by 1989. Certain programs, notably Medicare and Medicaid, are an exception to this generalization. Spending for national defense, however, grows from 6.6 percent of GNP to 7.4 percent, and net interest outlays increase from 2.9 percent of GNP to 3.3 percent. These spending trends are displayed in Table 6.

TABLE 6. COMPOSITION OF BUDGET OUTLAYS (By fiscal year)

	1983 Actual	1984 Est.	CBO Projections 1985	1986	1987	1988	1989
			In Billions of Dollars				
National Defense	211	235	265	295	328	360	396
Entitlements and Other Mandatory Spending							
Social Security	169	177	189	202	215	230	246
Medicare and Medicaid	76	86	98	108	123	140	158
Other	142	124	126	131	135	140	148
Nondefense Discretionary Spending	143	154	164	169	179	186	194
Net Interest	88	105	116	128	144	160	178
Offsetting Receipts	-33	-31	34	-40	-39	-40	-42
Total	796	850	925	993	1,084	1,177	1,278
			As a Percent of GNP				
National Defense	6.5	6.6	6.8	7.0	7.2	7.3	7.4
Entitlements and Other Mandatory Spending							
Social Security	5.2	5.0	4.9	4.8	4.7	4.7	4.6
Medicare and Medicaid	2.3	2.4	2.5	2.6	2.7	2.8	3.0
Other	4.4	3.5	3.2	3.1	3.0	2.8	2.8
Nondefense Discretionary Spending	4.4	4.3	4.2	4.0	3.9	3.8	3.6
Net Interest	2.7	2.9	3.0	3.0	3.2	3.2	3.3
Offsetting Receipts	-1.0	-0.9	-0.9	-0.9	-0.9	-0.8	-0.8
Total	24.6	23.9	23.8	23.5	23.8	23.9	24.0

Consequences of High Deficits

The risks associated with these baseline deficits are hard to assess because the ratio of the deficit to GNP will be far higher for a sustained period than anything experienced since World War II. When policy variables move outside the range of historical experience, analysts can no longer assume with confidence that empirical relationships estimated on the basis of past data will remain relevant to analyses of the current situation.

Clearly, however, unless current taxing and spending policies are changed, the budget deficit will grow and add to interest-rate pressures. The CBO projections assume that interest rates will decline gradually, in part because we assumed implementation of the budget resolution. But so far, full implementation has not occurred, and without further deficit reductions a somewhat higher interest-rate path may be likely.

High interest rates could have serious adverse effects. For example, as the recovery continues, business capital formation may experience more crowding out than has occurred thus far in the cycle. The potential for economic growth will then be reduced, and standards of living will be lowered in the long run. Conversely, growing capital inflows from abroad may offset to some extent the reduction in U.S. capital formation, but this implies an increasing commitment to pay interest and dividends to foreigners, which likewise will reduce future U.S. living standards.

Heavy reliance on foreign capital also leaves the United States vulnerable to changes in the psychology of foreign investors. If, for one reason or another, confidence in the U.S. economy fell and foreign capital inflows were reduced, real interest rates would rise, all else equal, so that the crowding out of U.S. capital formation would be intensified. In addition, higher real interest rates would aggravate the already fragile debt situation in the developing countries.

While controversy will undoubtedly continue regarding the magnitude of the risks described above, one effect of large deficits is almost inevitable: the net interest bill on the national debt will grow and grow. Table 6 shows the net interest bill under baseline assumptions. Even with declining interest rates, the net interest bill grows by $73 billion between fiscal years 1984 and 1989, or by 70 percent. If instead we assumed that interest rates remain constant at the levels of October 1983, the net interest bill would rise by $131 billion between 1984 and 1989 or $58 billion more than the baseline projections. A further one-percentage-point rise in interest rates would raise the 1989 net interest bill by still another $31 billion. Thus, large current deficits limit future spending options.

More important, large current deficits have a way of generating increased future deficits. Even with the interest rates assumed in this analysis, the net interest bill grows faster than the GNP in our projections. The tax increases or other spending cuts necessary to offset this rise become more and more arduous as time passes. Eventually,

financing the U.S. debt could become so burdensome that some would urge that the Federal Reserve absorb a portion of the deficits in order to avoid the necessary budgetary actions to reduce the debt burden. But if the Federal Reserve succumbed to such pressures—and Chairman Volcker has strongly stated that it will not—the money stock would grow rapidly and sharply higher inflation would follow.

Major Options for Reducing the Deficit

While large deficits may create major risks, abrupt or poorly designed measures to reduce deficits can also be a threat to economic efficiency and to the health of the economic recovery. Ideally, major spending cuts and tax changes should occur gradually or with long advance notice so that individuals and firms dependent on current tax and spending policies have time to adjust. Moreover, those affected must have some confidence that the changes will not be reversed at the last minute or soon after they have been implemented. The first budget resolution attempted to invoke such a "gradualist" strategy by putting off major tax increases until 1986.

Any analysis of the potential for reducing deficits in a major way by cutting spending must start with the fact that a large portion of federal outlays is devoted to only a few budget categories, as is shown in Table 6. Defense, entitlements, and net interest constituted 86 percent of outlays in 1983, and that proportion is projected to grow to 88 percent by 1989. In turn, Social Security and Medicare and Medicaid constituted 63 percent of

entitlements in 1983, growing to 73 percent by 1989. Note that by 1989, defense, Social Security, Medicare and Medicaid, and net interest will absorb almost 100 percent of revenues under current laws. The possibility of cutting other programs should not be ignored, but since they have already been declining relative to GNP, it seems reasonable to believe that major changes in defense, Social Security, or Medicare will be required if the course of total spending is to be altered significantly.

If changes in spending laws are deemed desirable, they should be undertaken soon. Cuts in defense procurement show up in reduced outlays only after a long time lag. Cuts in Social Security and Medicare ought to be phased in gradually so that beneficiaries and providers of health care services have time to adjust.

If the Congress wishes to restrain the growth in spending for Social Security, it could restrict the automatic cost-of-living adjustments (COLAs) for current and future recipients, limit eligibility for certain types of benefits, or reduce benefits for some recipients. For example, delaying Social Security COLAs for three months would save about $2.1 billion in 1985, and reducing them by one percentage point would save about $1.3 billion in 1985 and an additional $3.2 billion in 1986. Eliminating certain benefits—such as those paid to the children of early retirees—or reducing the maximum benefits paid to survivors and to families of retired workers to the maximum now allowed for disabled-worker families are examples of the

other two approaches. They would, however, save only relatively small amounts compared to modifying the COLAs.

Spending for Medicare and Medicaid has been growing rapidly, largely because of rising hospital costs. Three broad strategies are available within the Medicare program to reduce the federal deficit. First, significant spending reductions could be achieved by enacting further limits on payments to providers of medical care services. Options of this type include restraining growth in payments to physicians by freezing current reimbursement rates or establishing a fee schedule. Savings from this approach might range up to $900 million in 1985. Over the longer run, substantial savings also could be achieved by reducing the growth in recently established prospective hospital payment rates. Second, several approaches could be used to require beneficiaries to assume a greater share of their health care costs. These include raising premiums and increasing deductibles—both of which were recently recommended by the Advisory Council on Social Security—as well as increasing coinsurance. Federal savings would depend on the extent to which costs were shifted to beneficiaries. A third deficit-reduction strategy would be to raise the Hospital Insurance (HI) payroll tax, which finances almost 70 percent of total Medicare costs. Increasing the payroll tax rate in January 1985 by 0.25 percent for both employers and employees would raise trust fund revenues by about $6.5 billion in fiscal year 1985, for example.

The national defense projections shown in Table 6 are derived from the first budget resolution for 1984. The resolution provided for 5 percent real growth in budget authority for 1984-1986 and our projections assume the same rate of growth for 1987-1989. Past Administration budgets have asked for more; last year's budget, for example, asked for real growth averaging 8.7 percent a year for 1984-1986. Thus, the Congress will probably have to cut from the Administration's defense budget substantially just to keep defense spending to the resolution level. A further slowdown would be needed if defense is to contribute to reductions in the baseline deficits discussed earlier.

The nondefense discretionary programs will continue to be a focus of attention as a source of savings, but the likely reductions in this area will not suffice in themselves to balance the budget.

CBO has started its annual review of possible strategies and options for reducing spending and will present the results to the Congress within a few months. We are also taking a close look at the major recommendations of the President's Private Sector Survey on Cost Control, known as the Grace Commission, and will publish a separate analysis of these with the assistance of the General Accounting Office.

On the revenue side, there are basically three options: to raise tax rates, to broaden the base of existing taxes, or to introduce new taxes. The first option would be to raise rates under the existing corporate and personal income tax system—for example, by means of a surtax raising rates across

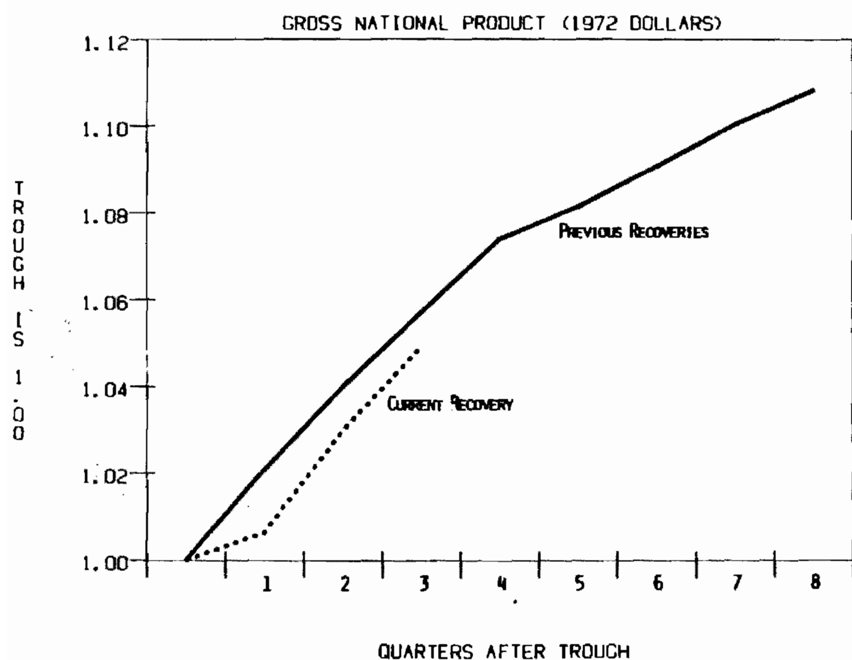
the board, or by modifying the indexing of the personal tax rate structure. These options are simple and could raise substantial revenue, but they would mean an increase in marginal tax rates on the current tax base, which would magnify existing inequities and inefficiencies in the tax system.

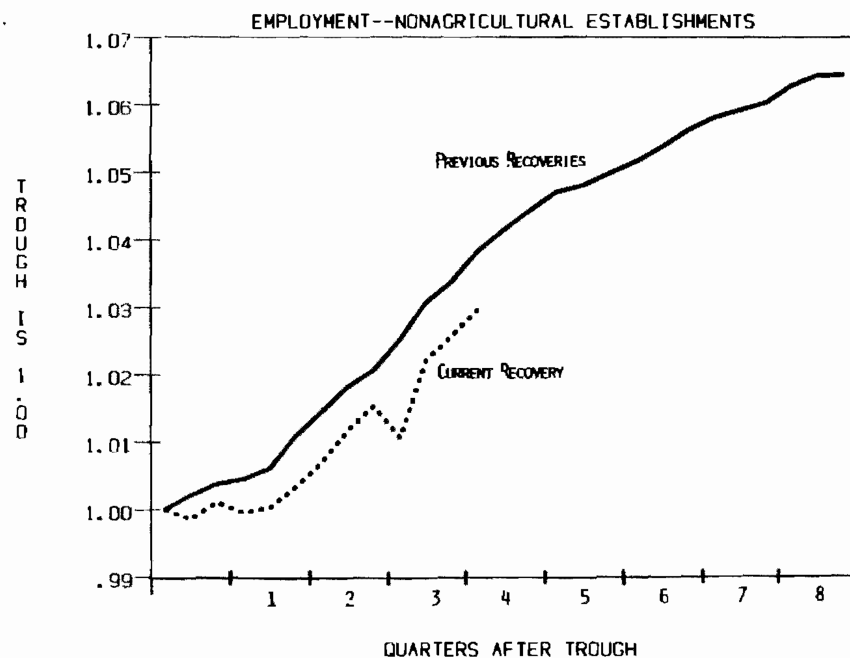
Broadening the base of existing taxes would hold marginal tax rates down and so might reduce some of the inefficiencies inherent in the tax system, while at the same time making taxes more equitable and simple in the eyes of the taxpayers. But the transition to a broader-based tax system could be disruptive for particular groups or sectors of the economy that have made plans based upon present tax laws. Moreover, in order to raise sufficient revenues through this device alone, the special treatment that the Congress has given in the past to activities it deemed to have special social significance—such as health care and homeownership—would have to be reconsidered.

Finally, introducing new taxes could raise substantial revenue. One approach would be a proportional tax on consumption in the form of a national sales tax or a value-added tax. An excise tax on oil, such as that proposed by the Administration on a contingency basis last January, could also be considered, as could a fee confined to imported oil. Another alternative would be an excise tax on energy regardless of source. The advantage of such taxes is that they would encourage saving and the conservation of energy. However, they might have an adverse effect on prices, at least temporarily. Many also object that the burden of such taxes

tends to fall less on high-income individuals than on lower-income groups, but if this is deemed a problem it could be approximately offset by modifications in the personal income tax and welfare system.

FIGURE 1. RECOVERY IS NEAR AVERAGE OF POST-WAR RECOVERIES





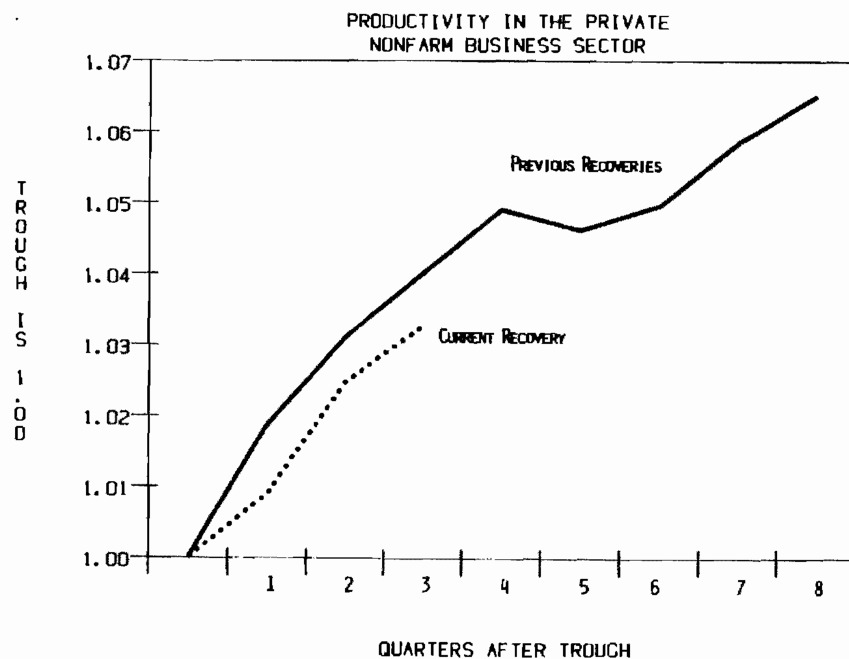
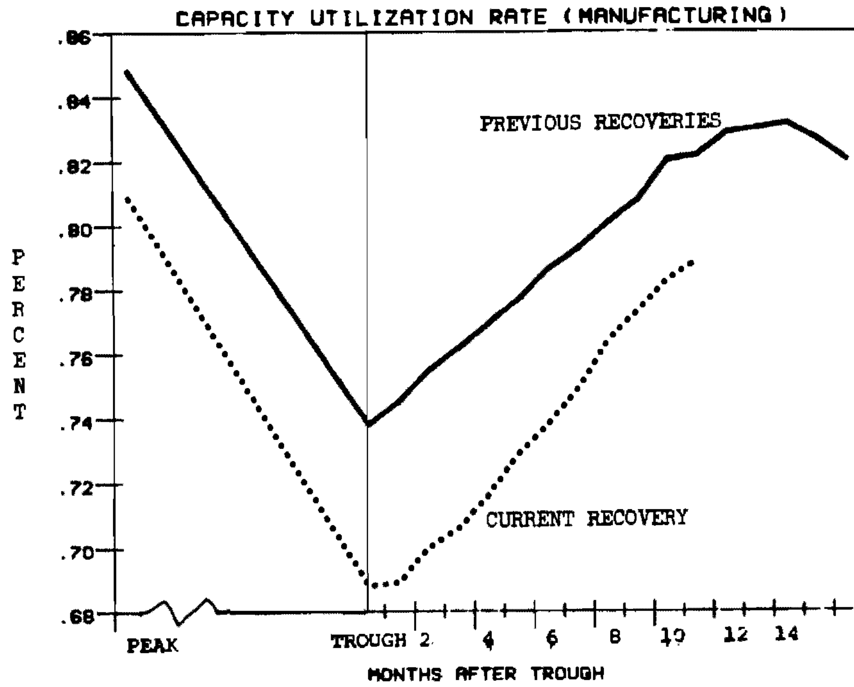


Figure 2. Measures Of Resource Utilization



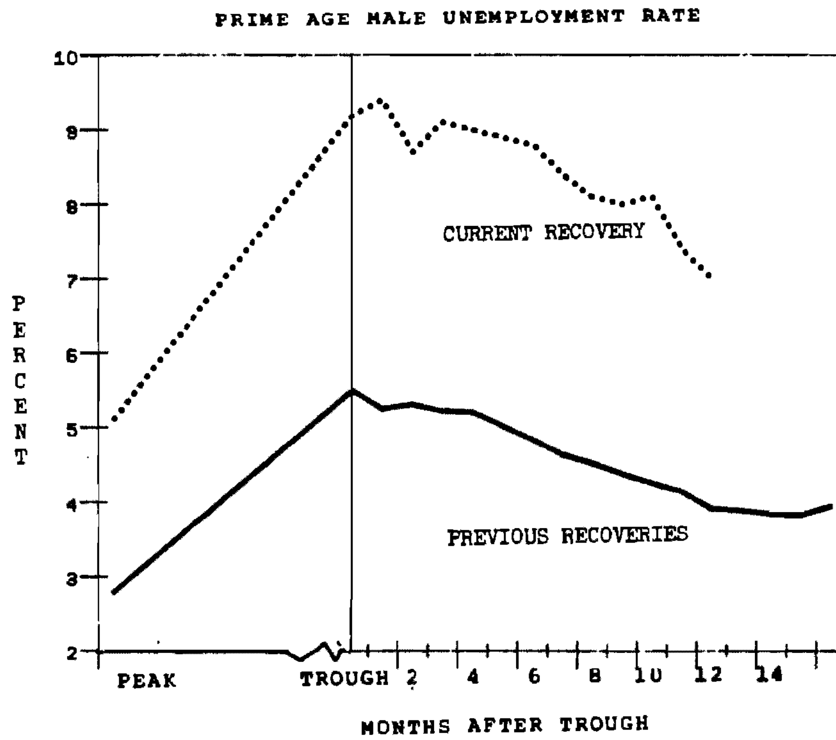
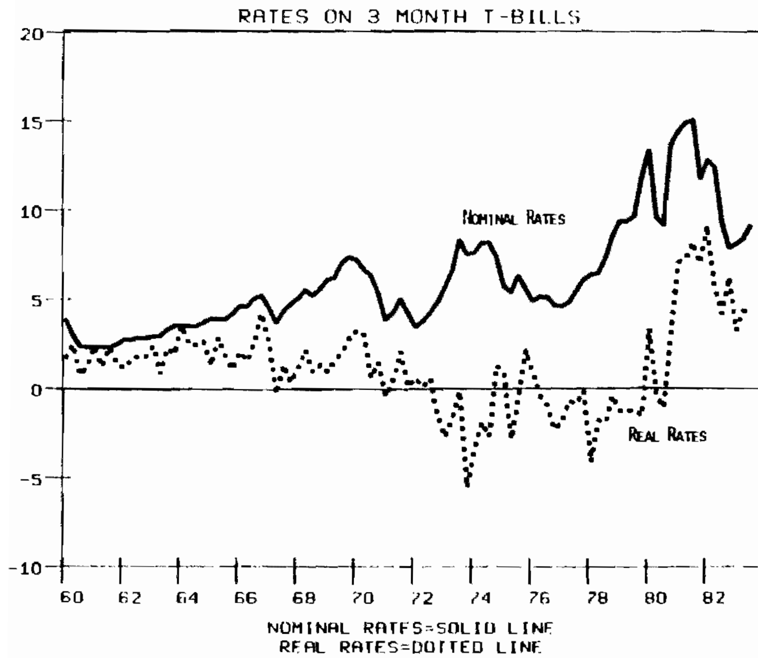
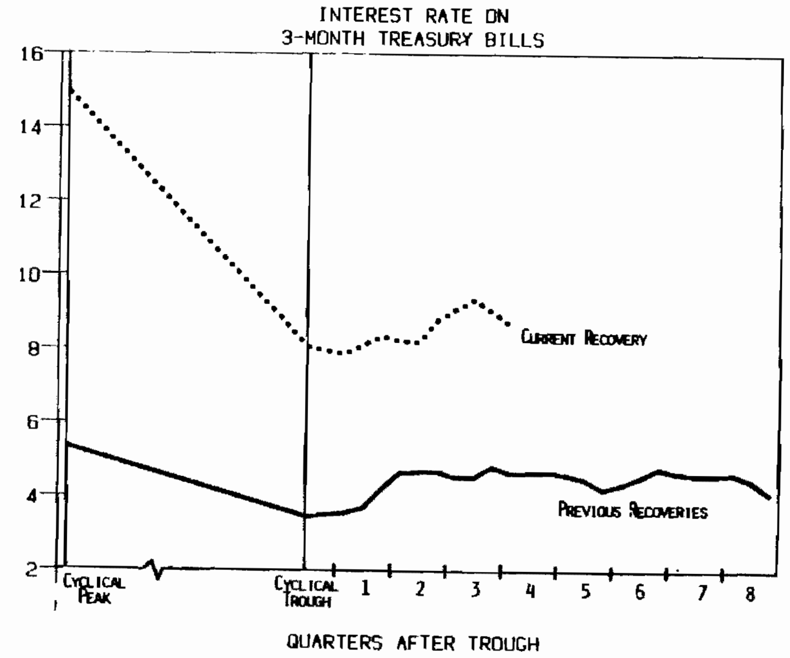
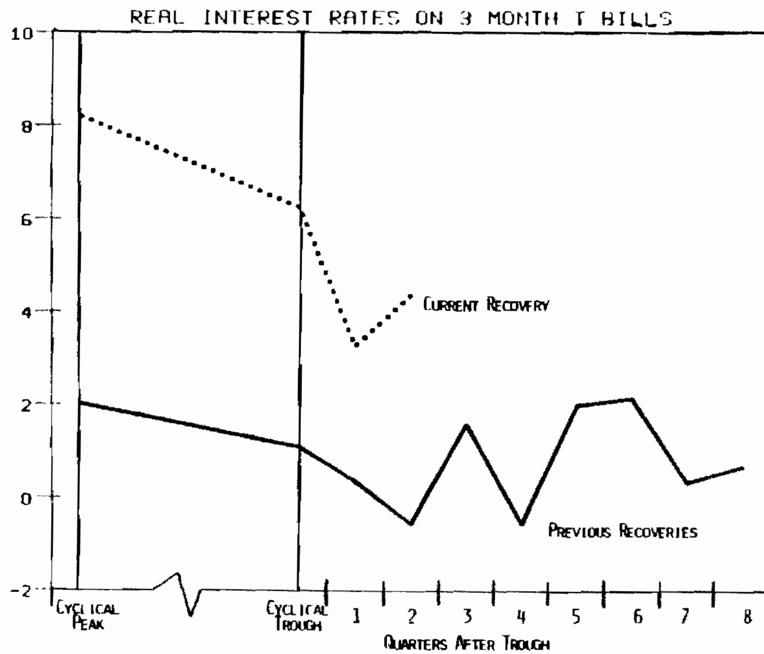


Figure 3. Interest rates remain high







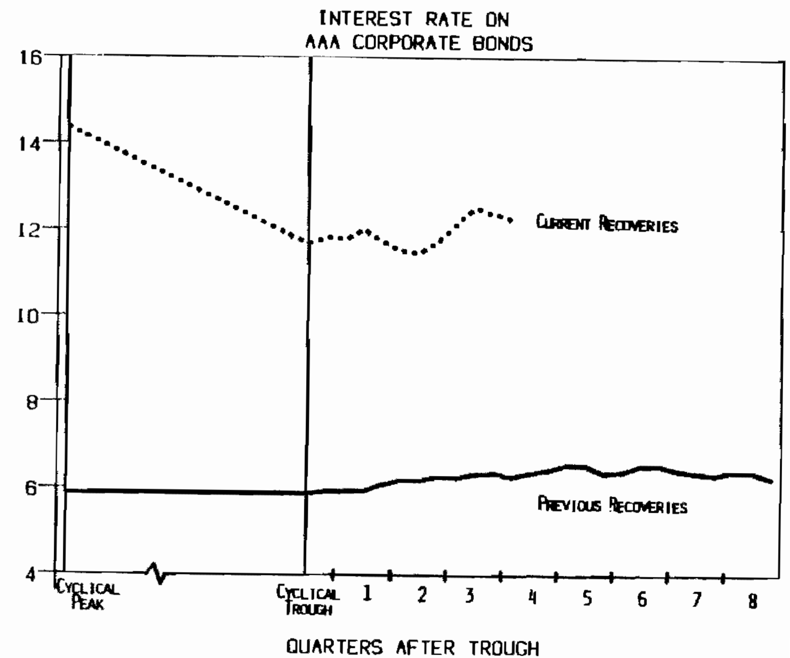
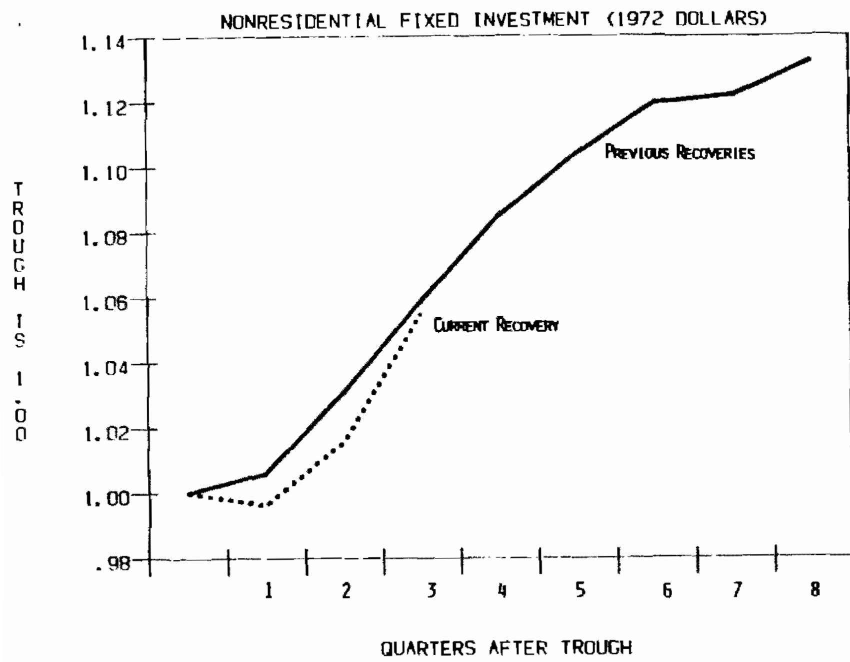
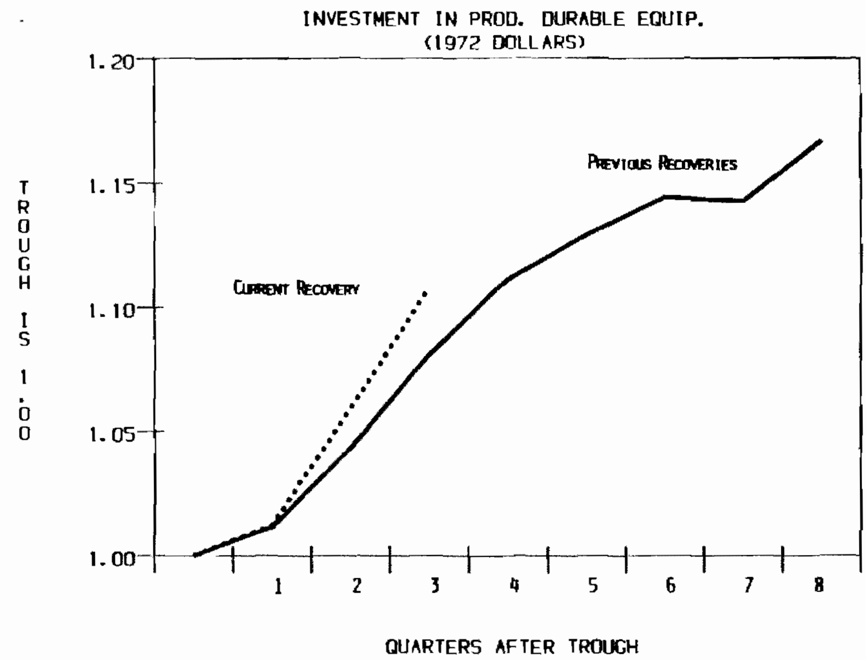
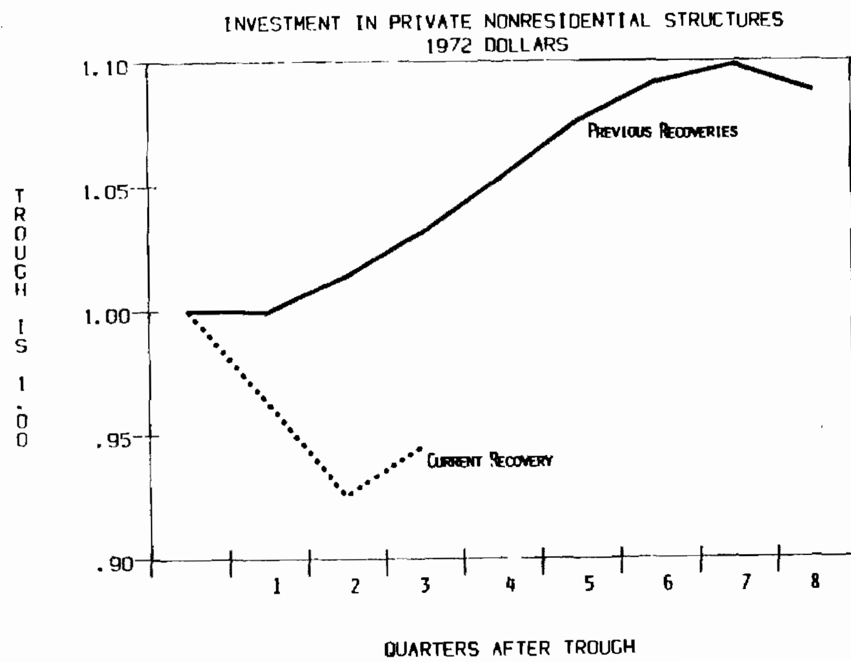


FIGURE 4. BUSINESS INVESTMENT HAS GROWN ABOUT AS USUAL







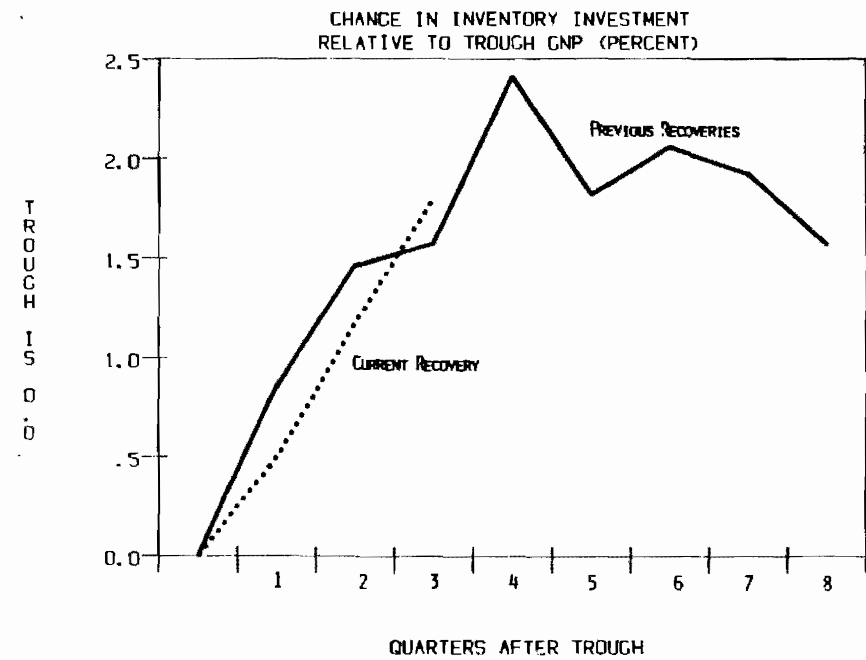
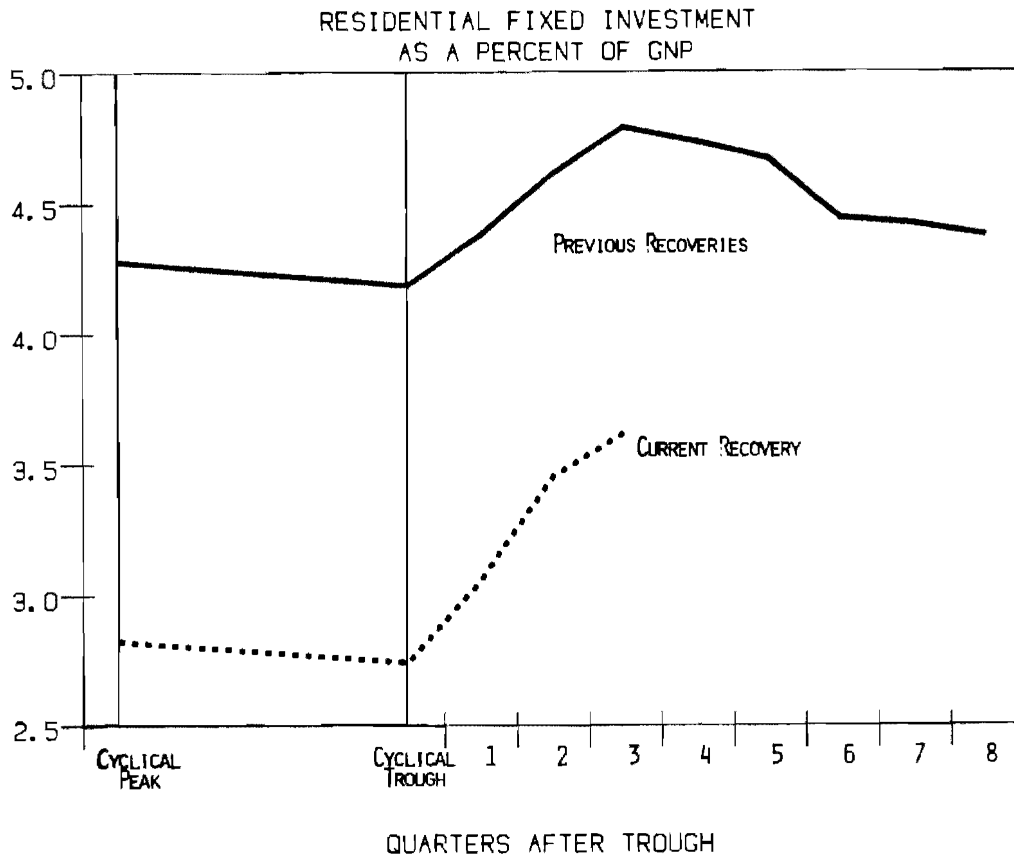


FIGURE 5. HOUSING INVESTMENT: RECOVERING FROM A LOW BASE



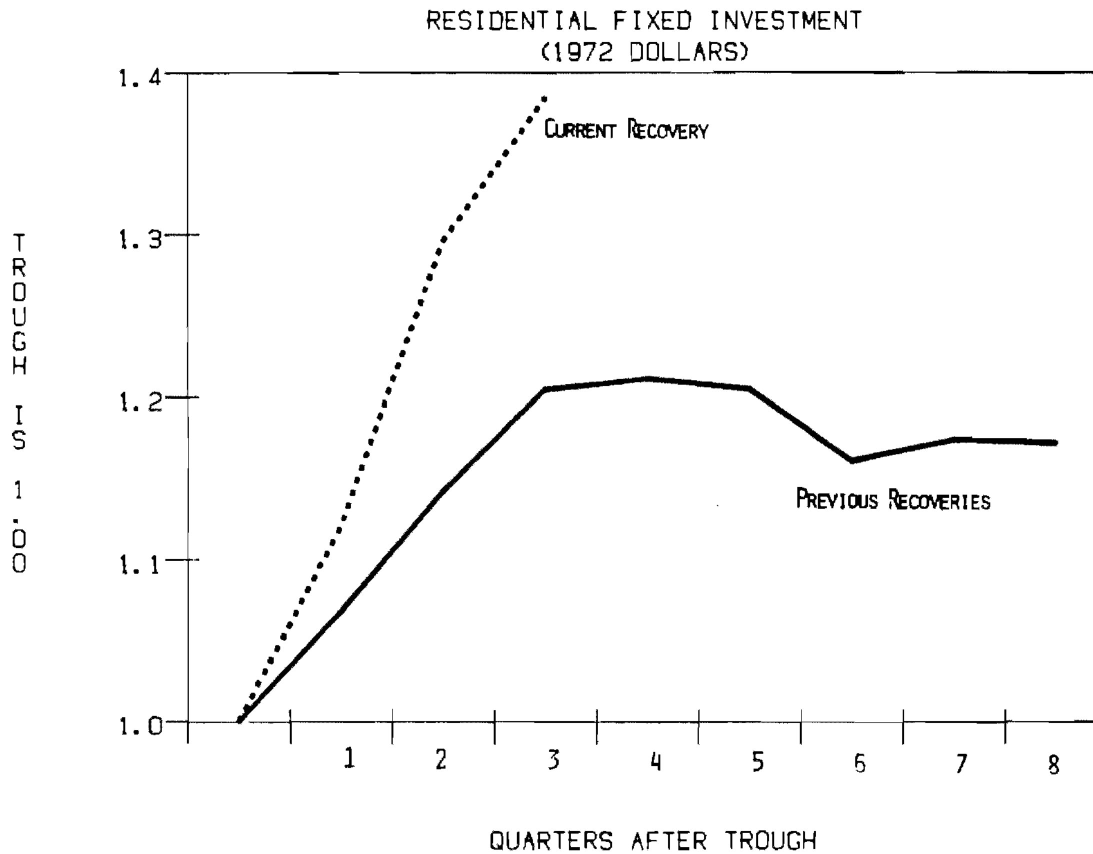


FIGURE 6. GROWTH IN NET EXPORTS AND GOVERNMENT PURCHASES IS WEAK