

Statement of Alice M. Rivlin  
Director, Congressional Budget Office  
before  
Committee on the Budget  
House of Representatives  
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Mr. Chairman and Members of the Committee:

I am pleased to have this opportunity to appear before you today as you begin your work on the fiscal year 1977 budget cycle. I think it would be most useful if I confine my remarks to three areas:

- . the economic outlook;
- . the baseline against which various budget options can be compared, and
- . the major issues that will be faced in formulating the fiscal year 1977 budget.

#### The Economic Outlook

Because the budget both affects and is affected by the economy, an examination of the economic outlook is the logical starting place for your deliberations on the fiscal year 1977 budget.

The legacy of 1975 is not one we can cherish. The economy went through three distinct phases last year. First, there was the sharp downswing during the first half of the year; next came a near record rebound during the third quarter and finally a rather moderate expansion (5.4 percent growth in real GNP) set in during the last quarter of 1975. The rate of inflation moderated to 7 percent by late 1975, which, while well below the double-digit pace of the preceding year, was extremely high by

historical standards. This slowdown of inflation occurred in part because of the recession and in part because of favorable developments in food and fuel markets. Unemployment which rose to a post-World War II high of above 9 percent in May declined in June and July but has been vacillating around the 8.3 percent level for five months.

Recent economic news, such as the December increase of 1.0 percent in both industrial production and the manufacturing work week, indicates that the recovery is continuing. Yet the economic outlook must remain one of guarded optimism. The latest CBO forecast anticipates the rate of growth of real GNP to fall somewhere in the 5 to 7 percent range this year and in the 4 to 6 percent range next year. Inflation -- as measured by the increase in the GNP deflator -- seems likely to continue at a 5 to 7 percent pace in both years. While the unemployment rate should come down from the current 8.3 percent level, it is unlikely to fall below 7 percent by the end of 1976; even a year later unemployment will probably be above 6.5 percent. Like all forecasts this one is predicated on a number of assumptions, the major ones being:

- . federal outlays at roughly the level required to maintain the services called for in the second concurrent resolution with adjustments made for inflation;
- . a rate of monetary growth of 7 percent per year;
- . federal receipts equivalent to those that would be generated by current tax laws, and
- . no sharp increases in food or fuel prices.

This economic outlook is consistent with those of the major commercial economic forecasting firms. The short run economic forecast contained in the President's budget also falls within the range anticipated by the CBO.

However, a word of caution is in order concerning the consensus that exists with respect to the economic outlook. Most forecasts are based on complex statistical models of the economy that have been estimated from historical relationships between various economic factors. During the past few years we have experienced unprecedented rates of inflation, unemployment, and interest rates, and therefore the reliability of the forecasting models, which are based on the experience of more normal times, can be questioned.

With this warning in mind, I think that there are a number of areas that should be monitored carefully. On the unemployment front, it is possible that the forecasts may turn out to be a bit too optimistic. The increase in the working-age population, the rising labor force participation rate, and the rapid rebound in productivity could translate expected increases in real output into smaller than expected gains in employment.

Second, interest rates have not risen as they generally do during a recovery, especially one accompanied by a slow growth in the money supply. An anticipated continuation of relatively low interest rates accounts for the expected increase in housing investment. If interest rates move up faster than expected, housing investment may not meet the expectations of the economic forecasts.

Another source of uncertainty that warrants close attention is the saving rate and expenditures on consumer goods. Throughout 1975 savings remained high by historical standards, thus acting as a restraint on demand and a damper on the recovery. If the saving rate falls significantly and spending on consumer goods and housing increases rapidly, then the outlook for economic growth will be brighter than expected.

Finally, it is worth mentioning the contributions anticipated from some of the other components of spending. Most of the rebuilding of inventories that occurs after a recession appears to have already taken place and little in the way of an extra boost to the recovery is expected from this source. State and local governments, skittish over the New York City situation and faced with high interest rates and voter resistance to increased spending, are anticipated to add far less to this recovery than past experience might lead one to expect.

In summary the outlook is one of continued economic growth, a persistence of inflation at current levels, and a slowly declining unemployment rate. In contrast with the forecast provided in Recovery: How Fast and How Far? (September 17, 1975), the current outlook must be considered slightly more optimistic for 1977, in large part because interest rates have remained lower than expected, as have food and fuel prices. But uncertainty shrouds this outlook and there appears to be no sector of the economy that is certain to give the economy a strong boost. It is in this economic environment that the debate on the budget options for Fiscal Year 1977 will take place.

### A Budget Baseline

It is essential in the process of comparing competing budget options to have a neutral reference point against which alternatives can be arrayed. Only with such a baseline can proposed shifts in spending priorities or taxing policies or suggested changes in the overall size of government be clearly seen. In the past the estimates for the current fiscal year published in the President's budget have served most often as the baseline against which the President's proposals for the budget year are compared. Budget options suggested by others generally have been contrasted to the President's proposals.

These practices have not worked well for several reasons. First they are not necessarily neutral and often are confusing. The current fiscal year estimates reported in the President's budget often contain policy changes that do not conform with enacted legislation or the probable outcome of pending Congressional actions. They may reflect proposed rescissions, deferrals and legislative initiatives.

Second, the comparison of the Administration's budget year request with the current year levels gives little insight either into the discretionary changes that are being proposed or the changes that are being suggested

in the real levels of various government programs. For example, a large increase in outlays in the income security function may represent no more than a continuation of existing programs whose spending levels are being forced up automatically by the entitlement nature of these programs. Similarly, what may seem to be a significant increase in the budget authority requested for a particular grant-in-aid program, in fact may turn out to represent less than the amount needed to provide recipient state and local governments with grants with unchanged purchasing power.

Here it seemed useful to the authors of the Congressional Budget and Impoundment Control Act to require the CBO to produce a baseline budget projection to which budget proposals, including the President's proposals, could be compared. As is required by the Budget Act, the Congressional Budget Office is releasing today its first Five-Year Budget Projections report which you have before you.



These projections represent the estimated cost of continuing on-going federal programs and activities at 1976 levels. The latest statement of Congressional policy -- namely, the Second Concurrent Resolution on the Budget-Fiscal Year 1976 (H. Con. Res. 466) -- is taken as the 1976 level. These projections assume "no policy changes" from the second concurrent resolution; current programs are continued except in those few instances, such as temporary study commissions, where the program is clearly of a one-time nature. Adjustments are made for inflation both in those programs that by law are indexed and in all others except those -- such as social services grants -- for which there is an explicitly mandated ceiling. Anticipated changes in the number of beneficiaries receiving social security, food stamps and the other entitlement programs are also taken into account. The projections of receipts are based on the assumption that the tax laws currently on the books are continued.

The outlays required to sustain services at current levels and the receipts collected under current tax laws depend, of course, on overall economic conditions. Because of the uncertainty surrounding the economic outlook,

particularly in the long run, the projections were made under two sets of economic assumptions. The first, path A, assumed a strong recovery from the current recession with the unemployment rate falling to 4.5 percent in 1980 and 1981. Under the second, path B, recovery would not be quite as strong; the unemployment rate would fall to just below 6 percent by 1981. The rate of inflation would remain at the historically high levels of 6 to 7 percent under path A, and would be somewhat lower under path B.

The CBO baseline projections indicate that, under path A, outlays of \$420 billion would be required in fiscal year 1977 to maintain the service levels provided by the second concurrent resolution. Under this path, receipts of \$383 billion would be generated by current tax laws and the resulting deficit would be \$38 billion. Under path B, outlays would be \$425 billion, receipts would be \$360 billion and the deficit would be \$65 billion.

The economic assumptions underlying the President's budget fall roughly in the middle of the range between path A and path B. Therefore an average of the path A

and path B projections from the CBO report can be used as an approximate -- and I underscore the word approximate -- baseline that can be used to highlight the changes in current service levels proposed by the President. Table 1 presents these differences on a function by function basis. The outlays in all but the revenue sharing function (850) and allowances implied by the President's request fall below the fiscal year 1977 approximation of the cost of providing the service levels called for by the second concurrent resolution. With respect to budget authority, the President's budget is above the "current policy" level with respect to allowances and in the national defense (050), international affairs (150), agriculture (350), and commerce and transportation (400) functions (see Table 2). Overall the President's budget falls below the baseline by some \$35 billion in budget authority and \$29.1 billion in outlays. On the receipt side, the President's budget proposes tax cuts that would lower federal receipts by roughly \$5 billion below the level implied by current policy.

It should be stressed that there is nothing sacred about the baseline levels. Changing national problems

and needs imply changing budget priorities which may mean that some programs and functions grow less than is required to maintain current levels of services. In fact, a general decision to moderate the growth of government spending may be consistent with all functions being funded below the levels required to maintain current services.

Major Budget Issues for Fiscal Year 1977

As was the case last year, the degree of economic stimulation or restraint provided by the federal budget promises to be a major issue. The CBO's economic outlook and those of the major commercial forecasting firms assume the approximate degree of stimulation provided by the baseline budget -- federal spending of roughly \$422 billion, the level needed to maintain current levels of services, and receipts of about \$370 billion, the level that would be generated by the current tax structure. Both more restrictive and more stimulative options need to be considered.

The President's budget represents one option in the direction of restraint. As I have already indicated, the President's budget calls for outlays roughly \$29 billion below the levels required to maintain the thrust of current

policy. On the revenue side, the President's budget is on the whole more expansionary than the baseline situation. The President's budget calls for personal and corporate income tax cuts in mid-1976 amounting to about \$11 billion over and above the levels that would result from the simple extension of the 1975 tax cuts. This expansionary move is partly, but not wholly, offset by proposed increases in social security and unemployment insurance taxes of \$5 billion (\$7.2 billion on a full-year basis) on January 1, 1977.

Compared to the baseline situation, the President's spending proposals would tend to slow the economic recovery but moderate the inflation rate. Some but not all of the effects of the spending reductions would be offset by the proposed tax reduction. Overall the growth of national output (GNP) during 1976 is estimated to be nearly 1.0 percent lower under the President's budget than under the current policy budget (see Table 3). During 1977, the Administration's budget is estimated as lowering output growth by another two-thirds of a percentage point. These reductions in the growth of output imply an unemployment rate six-tenths of a percentage point higher than that of

the baseline forecasts. This represents 600,000 fewer workers with jobs. This should not be construed as implying that the unemployment rate under the President's budget would rise -- but rather that it would fall more slowly.

Given an unaltered monetary policy, the lower outlays and the resulting smaller budget deficit proposed by the Administration should reduce inflationary pressures. However, only part of this reduction would occur by the end of 1977. A plausible estimate is that by 1980 the rate of inflation might be three to four-tenths of a percentage point lower -- that is, 4.6 or 4.7 percent if the inflation rate would otherwise be 5 percent -- under the Administration's 1977 budget as compared to a current policy budget.

It is important to emphasize the uncertainty that surrounds these estimates. The views that federal spending cuts are generally contractionary and that tax cuts generally stimulative are widely but not unanimously held among economists. Even among those who do subscribe to these views there are differences of opinion about the degree to which a given spending or tax change affects the

level of output. There is still more disagreement about the price effects of changes in government deficits. The estimates of fiscal impact I have just presented were arrived at after careful consideration and evaluation of different views, but they inevitably fall short of a precise set of measurements on which all experts would agree.

A second federal budget issue that will arise this year is that of the overall size of government. Over the past two decades, the federal budget has increased in size relative to the economy as a whole, from 18 to 24 percent of the GNP. The expansion of state and local governments has been even greater. Current budget decisions -- many of which appear small today but which involve substantial long-range commitments -- will determine whether this trend continues or is reversed.

The estimates contained in CBO's Five-Year Budget Projections report provide an indication of what would occur if current policies are maintained over the next half decade. On the outlay side, maintenance of current policies is consistent with a shrinking federal sector. Under path A, federal outlays would decline from their current level of 24 percent of GNP to 19 percent of GNP in 1981, while under the less optimistic economic assumptions

inherent in path B, they would fall to 21 percent of GNP. On the receipt side the reverse is true. If the economic growth rates assumed by paths A and B are achieved, federal receipts would rise from their estimated 1976 level of 19 percent of GNP to between 20 and 22 percent of GNP. This growth is the result of our progressive income tax system.

Consideration of the issue of the size of the budget is inevitably linked with the judgments that must be made on the feasibility and desirability of new initiatives and program terminations. The Five-Year Budget Projections report provides an indication of the composition of future federal budgets if priorities remained relatively unchanged. The President's budget provides an alternative which calls for a redirecting of resources toward national security and the development of physical resources but in the context of a government sector that grows less rapidly than the economy as a whole. By the end of February, the CBO will provide to the two Budget Committees its Annual Report which, in conformity with Section 202(f) of the Budget Act, will present a number of alternative ways of allocating various amounts of budget authority and outlays among the major functional areas. These, together with the



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President's proposal and the Five-Year Projections baseline, by no means exhaust the possible set of options that you will have to consider. Yet, I am hopeful that they will provide a useful range of illustrative budget options for debate and discussion.

ERRATA SHEET  
for  
STATEMENT OF ALICE M. RIVLIN  
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COMMITTEE ON THE BUDGET  
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Page 3, third line from bottom: Remove "rates."

Page 4, third and sixth lines from bottom: Replace "goods"  
with "durables."

Page 7, beginning of first full paragraph: Replace "here"  
with "hence."

Page 9, seven lines from bottom: Replace "\$38 billion" with  
"\$37 billion."

Table 3, first box, left-hand side: Replace "related" with  
"rate of."