Statement of

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Mr. Chairman and Members of the Committee:

There has been wide spread interest in "current services" or "current policy" budget projections as a neutral baseline for evaluating budget alternatives. These projections provide estimates of what would happen to the federal budget if current policies and services were to continue unchanged. Without any alteration in legislation or policy, budget figures can shift from one year to the next. For example, social security payments may rise because more elderly people claim benefits and as benefits are automatically adjusted to increases in the cost of living. Similarly, individual income tax collections will increase as taxable income grows. Careful consideration of the base from which a budgetary change is to be made contributes to the soundness of budgetary decisions.

The Committees on the Budget have adopted current policy or current services projections as a useful analytical tool. The Senate Committee used the Congressional Budget Office (CBO) current policy projections as the base for developing its recommendations for the first concurrent resolution on the 1977 budget. The House Committee used this concept for making five-year projections of the budget in its reports on the 1977 budget resolutions.

My testimony today, Mr. Chairman, will focus on three areas. First, I will summarize the results of the CBO five-year projections for fiscal years 1978 to 1982, which we have just completed.

Second, I will compare the CBO projections with the OMB current services estimates for fiscal year 1978. Third, I will discuss briefly our estimate of the impact of the recent shortfalls in federal spending, the changing economic outlook for the next two years, and the economic impact of a current policy budget for fiscal 1978.

CBO Five-Year Budget Projections

The CBO five-year budget projections are estimates of the receipts and outlays that would occur if present tax laws and all ongoing federal programs were to continue to operate for five more years at the levels specified in the Second Concurrent Resolution on the Budget for fiscal year 1977 (S. Con. Res. 139) adopted by the Congress on September 16, 1976. We use the second budget resolution as the latest expression by Congress of current resource allocations.

The basic methodology used for making the projections is fairly straight forward and is quite similar to that used by the Office of Management and Budget (OMB). The basic assumption for projecting receipts is simple -- the federal tax laws in effect in 1977 are assumed to continue unchanged. In particular, the provisions of the Tax Reform Act of 1976, including the tax cuts originally enacted in 1975, are assumed to continue in effect through fiscal year 1982, even though some of the tax reductions are scheduled to expire before then.

The spending projections assume that all current programs will continue except for those that are clearly temporary; that open-ended claims on the federal Treasury, such as interest on the public debt and social security payments, will respond to assumed economic and population changes in essentially the same way they have responded to such changes in the past; and that, for federal programs in which funding levels appear to be discretionary, funding is held constant in current dollar or, alternatively, in real terms.

Economic assumptions. Inflation, unemployment, and other levels of economic activity have an effect on both receipts and outlays. In order to develop budget projections, therefore, explicit assumptions must be made about what may happen to the economy over the next several years. In view of the uncertainty surrounding the economic outlook between now and 1982, the CBO projections report presents overall budget projections on the basis of two alternative sets of economic assumptions.

One set, designated as the baseline assumptions, is a relatively optimistic set of assumptions that is consistent with the long-range economic assumptions used by both Committees on the Budget for the Second Concurrent Resolution on the budget for fiscal year 1977. This path assumes that real economic growth, as measured by the gross national product (GNP) in constant dollars, will average 5.5 percent during the next three years and then taper down to 4.5 percent by 1982, as the unemployment rate falls below 5.0 percent in 1980 and reaches 4.1 percent by the end of the projection period. The rate of inflation, as measured by the annual percentage change in the Consumer Price Index (CPI), is assumed to fall from 5.7 percent in 1976 to 4.8 percent in 1978 and 1979 and then rise to 5.8 percent by the end of 1982 as the unemployment rate falls below 5.0 percent.

The second set of assumptions has a less rapid economic expansion and is generally consistent with the long-term outlook contained in various commercial models of the economy. This path assumes that real economic growth will fall from 6.4 percent in 1976 to 4.0 percent by 1979 and remain at that level through the end of the projection period. The unemployment rate only falls from an average of 7.6 percent in 1976 to 5.5 percent in 1982. The annual percentage change in the CPI is assumed to remain stable at 4.6 percent throughout most of the projection period.

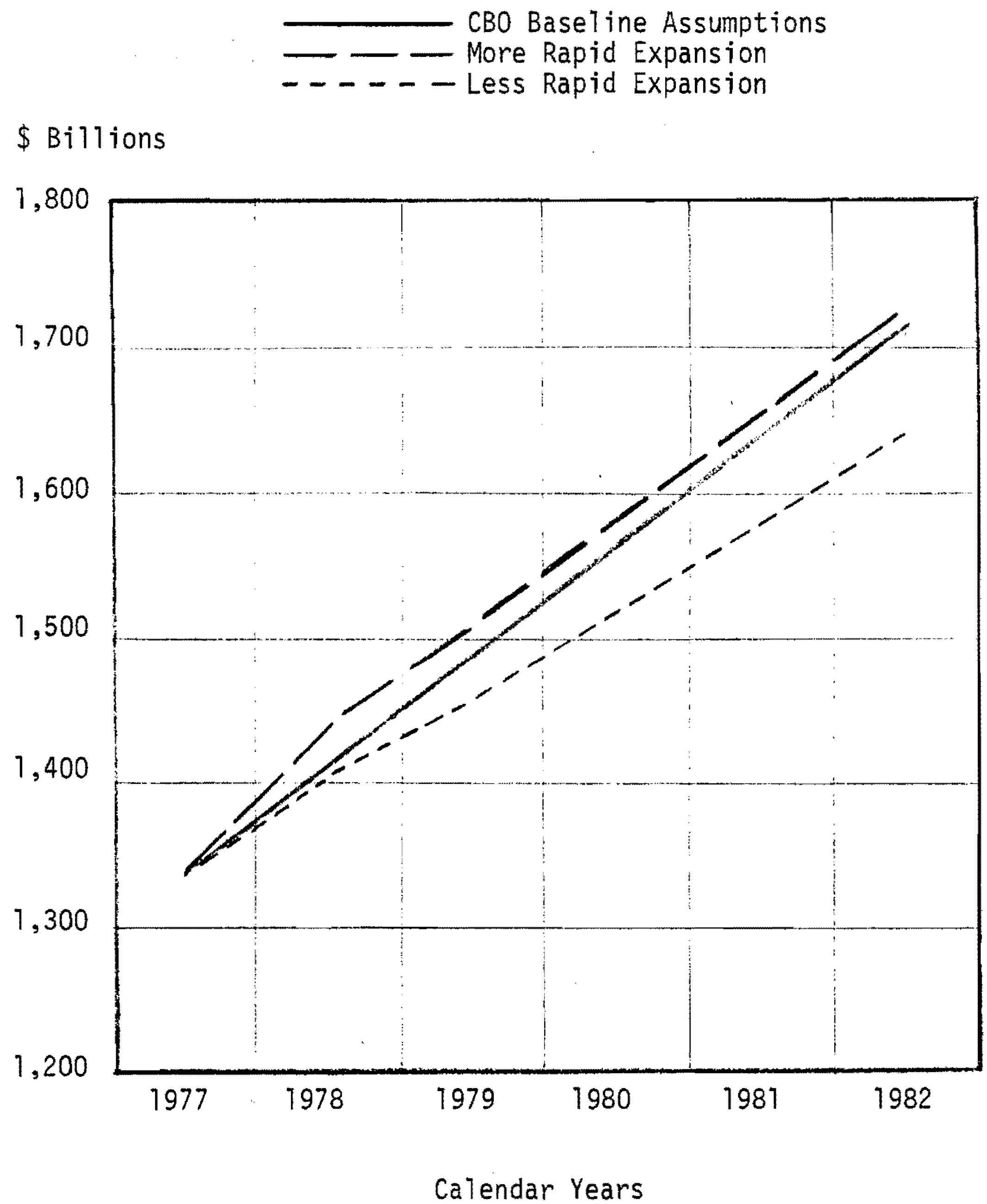
Mr. Chairman, we also developed projections of total budget receipts and outlays for a third set of economic assumptions for use by the Joint Economic Committee at the request of the Committee staff. This set assumes a more rapid economic growth in 1978 and 1979 than the CBO baseline assumptions, followed by a tapering down to a 3.9 percent annual growth in 1982. Under this path, the unemployment rate reaches 4.0 percent by the end of 1981, and the annual percentage change in the CPI rises from 5.0 percent in 1977 to 6.1 percent by 1982.

This third path, as shown in the chart on the next page, produces only a slightly higher real GNP in 1982 than the CBO baseline assumptions, but the five year pattern of more rapid growth at first followed by slower growth later produces higher output and lower unemployment during the intermediate years. The Joint Economic Committee has argued that such a pattern of tapering growth reduces the danger of over shooting the full employment target and touching off a new burst of inflation.

None of the sets is an economic forecast by the CBO of how the economy is likely to behave over the projection period. Rather, they are three of many possible paths that the economy could follow during the next several years.

GROSS NATIONAL PRODUCT IN 1972 DOLLARS

THREE ALTERNATIVE ASSUMPTIONS, 1977-82



The paths do not represent a necessary or predicted consequence of the budgetary projections associated with it. The CBO budget projections simply show what the federal budget would look like if services were maintained at current levels and if the economy by some means -- as a result of private consumption and investment, foreign demands, monetary policy, or some other developments -- achieved any of these paths. In other words, these projections do not necessarily represent the budgetary policy that would be required to achieve any of these paths under particular assumptions about the rest of the economy.

The economic paths are basically trend projections for calendar years 1978 to 1982 based on an October CBO forecast for 1977. Long-run historical patterns and relationships were used to generate the allocation of income shares, the required money stock growth, and other variables needed to project budget revenues and outlays.

Budget projections. Table 1 summarizes the results of the budget projections using the three sets of economic assumptions.

Table 1. Projections of Federal Budget Totals, 1978 - 1982
(Fiscal years, In billions of dollars)

	1977*	1978	1979	1980	1981	1982
Baseline economic assumptions						
Total receipts.................	362.5	407	464	526	594	668
Total outlays..................	413.1	451	480	514	548	586
Budget deficit (-) or surplus..................	-50.6	-44	-16	12	46	82
More rapid economic expansion						
Total receipts.................	362.5	410	471	535	604	678
Total outlays..................	413.1	451	482	517	555	595
Budget deficit (-) or surplus..................	-50.6	-41	-11	18	47	83
Less rapid economic expansion						
Total receipts.................	362.5	405	454	505	562	621
Total outlays..................	413.1	451	483	519	552	587
Budget deficit (-) or surplus..................	-50.6	-46	-29	-14	10	34

* Second Concurrent Resolution on the Budget for FY 1977 (S. Con. Res. 139)

Under the baseline economic assumptions, federal receipts would rise from the second budget resolution level of $362.5 billion in fiscal 1977 to $668 billion in 1982. Under the more rapid economic expansion path, federal receipts would be slightly higher throughout the projection period (by $10 billion in 1981 and 1982). Under the assumption of less rapid economic expansion, receipts would be $57 billion lower in 1982 than under the baseline economic assumptions. Under all three paths, federal receipts would rise faster than GNP largely because inflation and growth in real incomes push individuals into higher income brackets.

Total outlays are projected to increase from $413.1 billion in fiscal 1977 to $486 billion in 1982 under the baseline economic path and assuming that all federal programs are adjusted for inflation. Under the more rapid economic expansion path, total outlays in fiscal 1982 would increase at a slightly higher rate, largely due to the somewhat higher assumed rates of inflation. Projected total outlays under the less rapid economic expansion path also increase slightly more than under the baseline path, largely due to the higher assumed rate of unemployment. Under all three paths, federal outlays would not increase as fast as GNP so that the ratio of federal spending to GNP would fall from 22.5 percent in fiscal 1977 to 21.8 percent under the less rapid expansion path and to 19.3 percent under both the baseline path and the more rapid expansion path in 1982.

The federal deficit would be eliminated by 1980 under the baseline and more rapid economic expansion assumptions and assuming no policy changes. The potential budget surplus by 1982 would be quite large -- over $80 billion -- under both sets of economic assumptions. Under the less rapid economic expansion assumptions, the budget deficit would not be eliminated until fiscal year 1981, and the potential surplus in 1982 would be only about 40 percent of the amount projected under the other two economic paths.

As shown in table 2, almost three-fifths of the total increase in receipts between 1977 and 1982 under the baseline economic assumptions is accounted for by individual income taxes which are projected to more than double during this period. About one quarter of the increase is generated by rising social insurance taxes and contributions, which are projected to increase by 75 percent between 1977 and 1982.

Table 2. Projections of Federal Budget Receipts by Source Under Baseline Economic Assumptions
(Fiscal years, In billions of dollars)

	1977	1978	1979	1980	1981	1982
Individual income taxes.......	161.7	188	219	255	295	341
Corporation income taxes......	58.5	58	67	77	85	92
Social insurance taxes and contributions..............	107.1	124	139	152	170	188
Other taxes and receipts......	35.2	37	39	41	43	46
Total receipts............	362.5	407	464	526	594	668

On the spending side, over 50 percent of the projected increase in outlays between fiscal 1977 and 1982 (assuming no policy changes and the baseline economic path) is for benefit payments for individuals (e.g., social security, veterans' benefits, unemployment assistance, medicare and medicaid, civil service retirement, etc.), as shown in table 3. Outlays for national defense accounts for about one quarter of the increase, and the remaining one-fifth is for grants to state and local governments, net interest, and other federal operations.

Table 3. Projections of Federal Budget Outlays by Major Components Under Baseline Economic Assumptions (Fiscal years, In billions of dollars)

Major component	1977	1978	1979	1980	1981	1982
National defense..............	101	114	121	131	139	147
Benefit payments for individuals.................	184	196	212	231	252	275
Grants to state and local governments.................	48	49	48	48	50	53
Net interest..................	30	36	39	40	40	39
Other federal operations......	50	57	61	65	67	70
Total budget outlays......	413	451	480	514	548	586

As shown in table 4, if discretionary inflation adjustments were not made for grants to state and local governments, veterans' benefits, and federal purchases, total outlays would increase from $413 billion in fiscal 1977 to $542 billion in 1982, or $44 billion less than with full adjustment for anticipated inflation.

Table 4. Projected Increases in Federal Outlays
(Fiscal years, In billions of dollars)

	1978	1979	1980	1981	1982
Fiscal Year 1977 Total Outlays.......	413	413	413	413	413
Add: Commitments under Existing Law:					
Social security..............	8	16	25	35	47
Medicare and medicaid........	6	11	18	25	34
Pay increases for federal employees..................	4	8	11	16	20
Retired military pay and civil service retirement.........	1	3	4	6	8
Net interest.................	6	8	8	8	8
Defense purchases (lagged effect of prior appropriations increases)...........	8	8	11	11	11
All other federal spending (net).............	--	--	2	2	1
Subtotal, projected outlays under existing law commitments........	445	467	492	516	542
Add: Further Adjustments for Inflation:					
Maintain 1977 value of grants to state and local governments................	1	2	3	5	8
Maintain 1977 value of defense purchases..........	2	5	10	14	19
Maintain 1977 value of other federal purchases..........	2	5	6	9	14
Cost of living increase for veterans benefits..........	1	1	2	3	3
Indirect effect on interest of further adjustments for inflation..............	--	1	1	1	1
Total, projected outlays with further adjustments for inflation......................	451	480	514	548	586

These projections illustrate some facts about the built-in changes in the federal budget that are useful for policy decisions. As prices rise and the economy and population expand, federal spending will grow even if current policies remain unchanged. Receipts, however, will rise somewhat more rapidly than outlays. This occurs because, as the economy grows, more people will be working and paying taxes. Also, given the progressive nature of the individual income tax, as individual income rises a greater fraction of that income is paid in taxes. Hence, with no change in current policy and economic growth, the current federal budget deficit would disappear over time. The speed with which this occurs depends largely on the assumptions about economic growth and inflation.

Comparison of CBO and OMB Projections

The CBO and OMB methodologies are very similar, although there are some differences in the treatment of inflation, the extension of certain programs that expire under existing law, and of congressional action anticipated under the second budget resolution. In general, OMB does not include discretionary inflation adjustments in its current services estimates; it assumes the special counter-cyclical revenue sharing program will not be renewed, and uses a current estimate of 1977 spending that does not include $2 to $3 billion in additional outlays contemplated under the second budget resolution, which Congress did not act upon before it adjourned in October. The CBO projections include all three of these items.

The largest difference between the CBO and OMB projections is that CBO makes current policy projections for a period of five years, whereas OMB makes current services estimates for only one year beyond the current fiscal year. This difference stems from the different statutory requirements under the Congressional Budget Act of 1974. I believe the longer time period is more desirable for assessing the implications of existing budgetary commitments and possible options for altering those commitments. Annual budget decisions often have little short-run impact on budget totals or on the composition of the budget, but in the longer run, they can significantly influence both the size and the relative priorities of the budget.

Economic assumptions. In its November report, OMB provides current services estimates under four sets of economic assumptions. These four sets of assumptions are based on two inflation paths and two unemployment paths. As I discussed earlier, CBO has developed current policy projections for three different sets of economic assumptions. The CBO assumptions are generally within the range covered by the OMB assumptions as shown in table 5, except that the real economic growth rate for 1978 under the CBO most rapid economic expansion is above the range used by OMB, and the inflation rate assumed by CBO for 1978 is below the OMB range.

Table 5. Comparison of CBO and OMB Economic Assumptions, Calendar Years 1977 and 1978

	1977	1978
Current Dollar GNP (in billions)		
CBO........................	1,884	2,075-2,103
OMB........................	1,874-1,905	2,057-2,150
Real GNP Growth (percent change from pervious year)		
CBO........................	5.4	5.1-6.4
OMB........................	5.2-6.0	4.5-6.0
Inflation (percent change, fourth quarter over fourth quarter, GNP deflator)		
CBO........................	5.3	4.8
OMB........................	5.0-6.5	5.0-6.5
Unemployment Rate (annual average)		
CBO........................	6.8	5.7-6.1
OMB........................	6.4-6.9	5.5-6.5

Budget Projections. Given that essentially the same methodology is used by CBO and OMB, it is not surprising that after adjusting for the minor differences, the CBO and OMB budget projections for fiscal year 1978 are very close. For purposes of comparison, OMB's path IV economic assumptions are closest to CBO's baseline economic assumptions. The CBO and OMB receipts estimates for fiscal 1978 differ only by $3 billion as shown in table 6, and the CBO and OMB outlay estimates differ only by $1 billion when put on a comparable basis. While there are some differences in the components, the CBO and OMB estimates of total receipts and total outlays are remarkably similar, even though they were developed independently.

Table 6. Comparison of CBO Current Policy and OMB Current Services Budget Estimates for FY 1978
(In billions of dollars)

Major Components	CBO Baseline Path	OMB Path IV a/
Federal Receipts:		
Individual Income Taxes..................	188	185
Corporation Income Taxes.................	58	59
Social Insurance Taxes and Contributions..........................	124	123
Other Taxes and Receipts.................	37	37
Total Receipts......................	407	404
Federal Outlays:		
National Defense.........................	114	112
Benefit Payments for Individuals.........	196	197
Grants to State and Local Governments...	49	51
Net Interest.............................	36	34
Other Federal Operations.................	57	57
Total Outlays.......................	451	450

a/ The earned income credit is subtracted from OMB receipt estimates to provide comparability with the CBO receipt estimates. The OMB outlay estimates include discretionary inflation adjustments and renewal of anti-recession financial assistance, and excludes the earned income credit.

Short Run Budget and Economic Outlook

You asked me, Mr. Chairman, to comment on the recent shortfall in federal spending and the impact that this shortfall may have on future budget outlays. When I testified on this subject before the House Committee on the Budget on November 23, I made the following major points which I would like to reiterate:

(1) While the actual dollar effects on the economy of the shortfalls in government expenditures have not yet been fully evaluated, it seems likely that the shortfalls were an important contributor to the current economic lull, lowering the growth of real GNP by roughly 1.0 percentage points (annual rate) during the second and third quarters of 1976.

(2) The shortfall in federal spending in NIA terms occurred primarily in the first six months of calendar year 1976, with the greatest shortfall occurring in the second quarter (April - June). However, in contrast to the reported shortfalls in the unified budget, the spending shortfall was sharply reduced in the third quarter in the NIA accounts. Federal sector spending in the third quarter, adjusted to annual rates, appears to be back on track and ready to move forward on the path contemplated by the second budget resolution for fiscal 1977.

(3) The CBO estimates for fiscal year 1977 unified budget outlays are consistent with the second budget resolution level of $413.1 billion. We do not expect to experience a large net spillover of unexpected spending in fiscal year 1977 as a result of the recent spending shortfalls. While we expect some increases above our October spending estimates for a number of programs, these are likely to be offset by decreases in our estimates for other programs. Similarly, I do not expect a sharp reduction in our current scorekeeping estimates for 1977 outlays.

(4) On the receipts side, however, we expect a downward revision on the order of $5 to $10 billion below the $362.5 billion estimated for the second budget resolution for 1977. This is the result of a change in the economic outlook for the next year.

Even if federal spending increases close to the level set by the Congress for 1977, it is becoming clear that the economic assumptions underlying the second budget resolution were too optimistic. The economic lull which began this spring has been deeper and more prolonged than forecasters (including those at CBO) expected. Some reduction from the 7 percent growth rate during the first year of recovery was anticipated, if only because the shift from massive inventory liquidation in 1975 to accumulation in 1976 could not be expected to repeat itself. But even the shortfall in federal spending is not enough to explain several months of sluggish retail sales and no growth at all in real inventory investment. Weak demands in a number of sectors produced low real growth in the second and third quarters of calendar 1976, with no pickup yet in sight during the fourth quarter.

As I indicated earlier, we expect the federal spending shortfall to be a temporary factor and, therefore, it should have only a temporary effect on economic growth and unemployment. But since the federal shortfall was only one of a number of factors in the economic lull, its removal would not restore the economy to the GNP level assumed in the CBO and OMB current services and current policy projections.

The consensus among business forecasters now appears to be that the rate of real economic growth in calendar 1977 will be about 5 percent and the unemployment rate will average about 7 percent. These are somewhat more pessimistic than the assumptions in the OMB and CBO projections, which have been discussed earlier. Furthermore, a substantial number of business forecasters are assuming some additional fiscal policy stimulus early in 1977. Without the additional stimulus, the consensus among forecasters clearly would be for a growth rate below 5 percent and an unemployment rate in excess of 7 percent. On inflation, the consensus is in the neighborhood of a 5.5 percent rate of price increase.

If spending in 1977 is no stronger than forecasters are now projecting, the continuing gap between actual and potential output would probably have a dampening effect on investment spending in 1978. Indeed, econometric models are generally projecting an even weaker 1978 than 1977. It is too early to talk about a consensus forecast for 1978, but what forecasts there are suggest that if a current policy budget is followed, the economy will be significantly weaker than the assumptions underlying either the OMB or the CBO budget projections for fiscal year 1978.

Fiscal stimulus early in 1977 could affect real growth and unemployment during the year, and hence could move the economy closer to the OMB and CBO economic assumptions. Most forms of stimulus would have a larger effect in 1978 than in 1977, but current projections suggest the economy will still require stimulus in 1978 if it is to achieve the economic assumptions. Stimulative fiscal actions would require a new budget resolution for fiscal year 1977 and would cause an eventual increase in the rate of inflation, although not as large a one under current economic conditions as under a high-utilization economy. CBO's next economic report, to be released in early January, will discuss a number of fiscal policy alternatives and analyze their effects on economic growth, unemployment and inflation.