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before the
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Mr. Chairman, my testimony this morning will cover three areas:

- o The economic outlook as seen by the Congressional Budget Office (CBO) and the Administration;
- o The budget projections of CBO and the Administration; and
- o Revenue and spending options for closing the deficit.

THE ECONOMIC OUTLOOK

The economic forecasts of both the Administration and CBO are in close agreement for 1982. Real gross national product (GNP) is projected to rise by about 3 percent over the four quarters of the year, and the unemployment rate is expected to be in the neighborhood of 8 1/2 percent at year's end. The forecasts of inflation and short-term interest rates are also similar in 1982.

In 1983, however, the Administration's forecast for inflation and real growth is more optimistic than CBO's. While both forecasts imply virtually the same expansion of nominal GNP, the Administration looks for real GNP to grow by 5.2 percent over the four quarters of 1982, and for inflation (as measured by the GNP deflator) to fall to a rate of 5.5 percent. CBO expects real GNP to grow by about 1 1/2 percentage points less than the Administration does in 1983, and the GNP deflator to rise by about 1 1/2 percentage points more.

As shown in Table 1, the Administration's economic assumptions for 1984 and beyond are also more optimistic than CBO's. Compared with CBO's baseline assumptions, the Administration projects higher real growth and sharper declines in inflation, unemployment, and interest rates.

The Administration's real growth assumptions for 1984-1987 are near the upper end of historical experience. In comparable four-year periods

TABLE 1. COMPARISON OF CBO AND ADMINISTRATION ECONOMIC ASSUMPTIONS (By calendar year)

	1982	1983	1984	1985	1986	1987
Gross National Product (GNP)						
Current dollars (percent change, year to year)						
CBO Baseline	7.5	11.9	10.4	9.7	9.4	9.1
Administration	8.1	11.5	10.2	9.7	9.2	9.0
Constant (1972) dollars (percent change, year to year)						
CBO Baseline	-0.1	4.4	3.6	3.5	3.5	3.5
Administration	0.2	5.2	5.0	4.7	4.4	4.3
Prices						
GNP Deflator (percent change, year to year)						
CBO Baseline	7.5	7.3	6.6	6.0	5.7	5.4
Administration	7.9	6.0	5.0	4.7	4.6	4.5
Consumer Price Index (percent change, year to year)						
CBO Baseline	7.5	6.9	6.9	6.4	6.0	5.7
Administration	7.3	6.0	4.6	4.8	4.6	4.5
Unemployment Rate (percent, annual average)						
CBO Baseline	8.9	8.0	7.4	7.2	6.9	6.7
Administration	8.9	7.9	7.1	6.4	5.8	5.3
Interest Rate (91-day Treasury bills, percent, annual average)						
CBO Baseline	12.0	13.2	11.3	9.4	8.7	8.1
Administration	11.7	10.5	9.5	8.5	7.0	5.5

SOURCES: Budget of the United States Government, Fiscal Year 1983, pp. 2-5 and 2-7, and CBO, Baseline Budget Projections for Fiscal Years 1983-1987 (February 1982), p. 15.

following previous postwar recoveries, real growth averaged 3.4 percent a year and ranged between 2.0 and 5.2 percent a year. The Administration assumes an average rate of growth of 4.6 percent a year between 1984 and 1987. CBO, in its baseline projections, assumes an average annual growth rate of 3.5 percent.

The slower real growth projected by CBO results largely from the higher real interest rates in the CBO forecast that serve to dampen the recovery in economic activity. As discussed below, both CBO and the Administration project large budget deficits. This will result in a marked increase in Treasury borrowing, putting upward pressure on interest rates. At the same time, the Federal Reserve's targets for monetary growth may act as a brake on economic growth during the next few years. Some analysts fear that the combination of a stimulative fiscal policy and a tight monetary policy will push interest rates to very high levels and thereby limit economic growth. The outcome is very hard to predict, however, because this policy combination is virtually without precedent. Nevertheless, there is a significant risk that the outcome could be even weaker growth than projected by either the Administration or CBO.

BUDGET PROJECTIONS

CBO Baseline

As shown in Table 2, CBO's baseline budget projections, which are based on a continuation of current tax and spending policies, show the deficit increasing substantially, from \$157 billion in fiscal year 1983 to \$248 billion in 1987. In all previous CBO baseline projections, revenues grew faster than outlays and the budget began to show a surplus

TABLE 2. COMPARISON OF CBO BASELINE AND ADMINISTRATION CURRENT SERVICES BUDGET PROJECTIONS, FISCAL YEARS 1982-1987

	1982	1983	1984	1985	1986	1987
	<u>In Billions of Dollars</u>					
Revenues						
CBO Baseline	631	652	701	763	818	882
Administration Current Services ^a	626	653	704	778	843	907
Outlays						
CBO Baseline	740	809	889	971	1,052	1,130
Administration Current Services ^a	728	799	869	946	1,019	1,082
Budget Deficit (-)						
CBO Baseline	109	157	188	208	234	248
Administration Current Services ^a	101	146	165	168	175	175
	<u>As a Percent of GNP</u>					
Revenues						
CBO Baseline	20.6	19.0	18.5	18.3	18.0	17.7
Administration Current Services ^b	20.3	19.0	18.6	18.7	18.5	18.3
Outlays						
CBO Baseline	24.2	23.6	23.5	23.3	23.1	22.7
Administration Current Services ^b	23.6	23.3	22.9	22.7	22.4	21.8
Budget Deficit						
CBO Baseline	3.6	4.6	5.0	5.0	5.1	5.0
Administration Current Services ^b	3.3	4.2	4.3	4.0	3.9	3.5

SOURCES: Budget of the United States Government, Fiscal Year 1983, pp. 3-8, and CBO, Baseline Budget Projections for Fiscal Years 1983-1987 (February 1982), p. 16.

a. Includes proposed defense spending growth. The Administration has also classified certain social insurance contributions as offsetting collections to spending, thereby reducing both revenues and outlays but leaving the deficit unchanged.

b. Based on Administration GNP projections.

within two or three years. Projected revenues grew more rapidly than the economy, because inflation and economic growth pushed individuals into higher income tax brackets. Projected baseline outlays, on the other hand, grew more slowly than the GNP, because most spending was assumed merely to keep pace with inflation.

The present baseline budget projections are quite different from those of the past. As a result of the tax cuts contained in the Economic Recovery Tax Act of 1981, baseline revenues grow less rapidly than the economy. Projected baseline outlays still grow less rapidly than the economy, but at a faster pace than revenues. The baseline budget projections are therefore characterized by large and growing deficits.

Revenues. Baseline revenues are projected to rise from \$631 billion in 1982 to \$882 billion in 1987--an increase of 40 percent in five years. This represents an average growth of 6.9 percent a year, compared with an assumed average growth in nominal GNP of about 10 percent a year. Baseline revenues as a proportion of GNP are thus projected to decline from 21.1 percent in 1981 to 17.7 percent in 1987 (see Table 2). The decline is relatively rapid during 1982, 1983, and 1984, when staged reductions in individual and corporate income taxes take place. The decline levels off thereafter, when personal income tax brackets are indexed to the Consumer Price Index in order to prevent effective tax rates from rising with inflation.

Outlays. Baseline outlays are projected to increase at a faster pace than revenues. Under baseline assumptions, outlays would rise from \$660 billion in 1981 to \$740 billion in 1982 and \$1.1 trillion by 1987.

This represents an average annual growth in outlays of 8.9 percent during the projection period (1982 to 1987), or about one percentage point less than the assumed growth in GNP and two percentage points higher than the projected growth in revenues. Under baseline assumptions, outlays would decline only slightly as a share of GNP--from 24.2 percent in 1982 to 22.7 percent in 1987. By 1987, the ratio of federal outlays to GNP would be about the same as it was in the 1975-1980 period, but would be higher than for the earlier postwar years.

Budget Deficit. Under baseline assumptions, the unified budget deficit would rise significantly through 1984, both in dollar terms and as a percent of GNP. The deficit would equal \$109 billion in 1982, \$157 billion in 1983, and \$188 billion in 1984. As a share of GNP, the deficit would be 3.6 percent in 1982, 4.6 percent in 1983, and 5.0 percent in 1984.

From 1984 onward, baseline revenues and outlays would grow at similar rates. The deficit would grow in dollar terms, although it would remain roughly constant as a percent of GNP. By 1987, the deficit would equal \$248 billion, or 5.0 percent of GNP.

Administration Current Services

As shown in Table 2, the Administration's current services projections, which include their proposed defense spending growth, also show large and growing deficits. With no further spending cuts or tax increases, the Administration projects a deficit of \$146 billion in fiscal year 1983, rising to \$168 billion in 1985.

Do Deficits Matter?

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

Unfortunately, the current budget problem is neither exclusively nor principally recession-related. It is, rather, a problem of prospective chronic budget deficits. Without significant legislative changes in federal spending and tax laws, the trend appears to be one of large and growing federal budget deficits, not only during the recovery from the current recession but for the foreseeable future as well. No clear economic rationale exists for the persistence of deficit spending year after year, and the distinct possibility exists that the very large and rising budget deficits projected for the future could seriously impair the overall performance of the economy.

- o The increased competition for funds induced by federal government borrowing drives up interest rates, crowding out private-sector investment. Ultimately, the reduction in private investment hurts productivity growth and worsens inflation. In the face of chronic budget deficits, these adverse effects are compounded by the further increase in outlays for interest on the federal debt caused by higher interest rates.

- o Increased federal government borrowing exacerbates inflationary pressures if the Federal Reserve is induced to expand the money supply to limit the rise in interest rates.

SPENDING AND REVENUE OPTIONS TO REDUCE THE DEFICIT

Administration Proposals

The Administration has proposed a series of tax and spending changes that it estimates will reduce the deficit to \$92 billion in 1983, \$72 billion in 1985, and \$53 billion in 1987. CBO has prepared a reestimate of these proposals that will be released tomorrow when I testify before the Senate Committee on Appropriations.

The Administration's deficit reduction proposals for the 1983-1985 period are concentrated largely on the spending side of the budget. The biggest share of the outlay reductions--40 percent--would be accomplished largely through the appropriations process by holding back increases or cutting nondefense discretionary programs. Another 29 percent of these outlay reductions are to be achieved through legislative proposals to cut back entitlement programs, primarily Medicare, Medicaid, food stamps, and Aid to Families with Dependent Children (AFDC). No cuts for Social Security are proposed.

An estimated 28 percent of outlay savings would be achieved through various management initiatives, such as accelerated leasing of Outer Continental Shelf lands, the sale of surplus or underused federal property, improved debt collection procedures, and further restraint in federal pay. Finally, proposed increases in user fees that would be counted as offsetting receipts make up the remaining 3 percent of the proposed outlay savings.

Only a little more than 20 percent of the Administration's deficit reduction proposals involve revenue increases. Nearly 75 percent of the increases during 1983-1985 would come in corporate income taxes, offsetting about 60 percent of the corporate tax reduction enacted in the Economic Recovery Tax Act (ERTA) for that period. No proposals are made in the February budget to delay or eliminate any of the scheduled rate reductions in individual income taxes that also were enacted in ERTA.

Other Spending Reduction Options

Given the magnitude of the deficit problem, spending reductions in addition to those proposed by the Administration should be considered. Defense spending and major entitlement programs cannot be left off limits if substantial progress is to be made in reducing the deficit.

Defense. As shown in Table 3 below, large potential outlay savings could result from limiting the Administration's proposed real growth in defense spending. The Administration's proposed defense budget, according to CBO calculations, includes an average real growth in budget authority averaging about 6 percent a year over the 1982 to 1987 period, with higher 9 percent growth in 1982-1985. Providing a steady real growth of 7 percent in budget authority would reduce outlays by almost \$7 billion in 1983 and \$11 billion in 1985, since spending would be pushed into later years. This assumes a proportional reduction in all non-pay accounts. Reducing real growth in budget authority to a steady 3 percent over the 1982 to 1987 would reduce outlays by \$10 billion in 1983 and \$53 billion in 1987. While the outlay savings are relatively small in the early years, they become much larger in later years. Since the major

budget problem is one of chronic long-term deficits, the fact that the outlay reductions are relatively small at the outset does not diminish the usefulness of this option.

TABLE 3. OUTLAY REDUCTIONS FROM REDUCING REAL GROWTH IN BUDGET AUTHORITY FOR DEFENSE (By fiscal year)

	1983	1984	1985	1986	1987
7 percent real growth	7	9	11	9	1
5 percent real growth	8	14	22	27	28
3 percent real growth	10	19	32	44	53

a. Based on the Administration's February budget request, after adjustment for CBO technical reestimates and inflation assumptions.

Entitlements. While the Administration has proposed some reductions in entitlement spending, other options are possible. Most entitlement programs take the form of federal benefit payments to individuals. These payments constitute about half of the federal budget--\$366 billion in 1982. Of this total, nearly two-thirds goes for retirement programs, the largest of which is Social Security. Means-tested programs directed toward low-income persons--including many elderly persons--account for only 18 percent of all outlays for payments to individuals.

The Administration's proposed budget for 1983 includes cuts in 18 entitlement programs, with an outlay reduction estimated by the Administration at \$11.7 billion. Over 60 percent of these cuts would affect means-tested programs, including food stamps, Medicaid, and AFDC. About

30 percent of the cuts would be in non-means-tested programs, including Medicare, federal civilian and military retirement, and railroad retirement.

Besides the changes in retirement programs the Administration has already proposed, other options could be considered and the scope broadened to include Social Security. Social Security is more than half again as large as all the other retirement programs combined. Since the Social Security recipient population is so large, the burden of a benefit reduction generating sizable savings could be distributed widely, lessening the sacrifice for each individual beneficiary.

Much of the rapid growth in retirement benefits has resulted from automatic COLAs. In the last three years, the CPI--which determines most federal COLAs--has risen faster than wages. Thus, retirement benefits have maintained their purchasing power, while wages of the working population have fallen in real terms. In addition, the CPI contains a flaw in its treatment of housing costs, which results in overestimating price increases during periods of rapidly rising home mortgage interest rates. Consequently, the CPI has risen faster than other price indexes during the last five years.

A change in the COLA for retirement programs--Social Security, civilian and military retirement, and railroad retirement--could achieve large short-run savings. This approach would affect both current and new beneficiaries, thereby spreading the burden widely. Beneficiaries with low total incomes would find it difficult to absorb even a small decline in their real benefits, however.

One potential change in the automatic COLA in federal retirement programs would reduce the adjustment to two-thirds of the increase in the CPI, with some or all of the remaining one-third granted at the Congress's discretion. If this change were implemented with the July 1982 and March 1983 COLAs and no discretionary supplements were provided, savings would be \$6 billion in 1983 and \$29 billion in 1987 (see Table 4).

TABLE 4. ESTIMATED OUTLAY SAVINGS FROM REDUCING COST-OF-LIVING ADJUSTMENTS (COLAs) IN THE SOCIAL SECURITY, FEDERAL CIVILIAN AND MILITARY RETIREMENT, AND RAILROAD RETIREMENT PROGRAMS^a (By fiscal year, in billions of dollars)

	1982	1983	1984	1985	1986	1987
Automatic two-thirds of COLA with no discretionary supplement	1	6	10	16	23	29
Delay COLA from July to October	3	3	4	4	4	4
Skip 1982 COLA	3	14	16	18	20	21
Reduce COLA by one percentage point (in 1982 only)	---	2	2	2	2	3

a. Changes in the COLAs for Social Security and Railroad Retirement are assumed to occur in July 1982, whereas changes for the federal civilian and military retirement programs are assumed to occur in March 1983.

Alternatively, smaller savings could be achieved by permanently delaying the annual COLA for Social Security and railroad retirement from July 1 to October 1. The COLA for Civil Service Retirement, already changed from twice to once a year, could be delayed from March to June. This would be equivalent to about a 2 percent reduction in benefits, producing savings of about \$3 billion in 1983 and \$4 billion in 1987. Some other options are also shown in Table 4.

Other Revenue Increase Options

Other revenue-increasing options beyond those proposed in the President's budget could also be considered. Table 5 lists a number of possibilities, including scaling back the individual and business tax reductions enacted last year in the Economic Recovery Tax Act, and doubling existing excise taxes on alcohol, tobacco, telephones, and gasoline. Eliminating the scheduled 1983 rate cut and the 1985 indexing of the individual income tax cut would increase projected revenues by large amounts--over \$50 billion in 1985, and about \$100 billion in 1987.

TABLE 5. POSSIBLE REVENUE INCREASE OPTIONS, FISCAL YEARS 1983-1987 (In billions of dollars)

	1983	1984	1985	1986	1987
Eliminate 1983 income tax rate cut	9	37	40	44	47
Eliminate indexing	--	--	12	30	51
Repeal safe-harbor leasing	3	4	6	7	8
Limit ACRS depreciation increase to 150 percent declining balance	--	--	3	14	19
Reduce ITC to 3 1/3 percent for 3-year equipment and 6 2/3 percent for 5-year equipment	2	4	6	8	10
Double existing excise taxes on alcohol, tobacco, telephones, and gasoline	10	12	13	14	14

A number of other options are discussed in more detail in Chapter XII of Part III of CBO's annual report, Reducing the Federal Deficit. These include increased energy taxes and broad-based consumption taxes, such as a value-added tax (VAT). A \$5 per barrel fee on imported oil would raise as much as \$17.5 billion a year, although a substantial portion of that would be offset by lower corporate and individual income taxes. It would increase incentives for energy conservation and help to reduce U.S. dependence on foreign oil. A broad-based VAT could raise as much as \$10 to \$15 billion a year for each percentage point of the tax. If such a tax were substituted for part of the individual or corporate income tax, both of which impose a significant tax on saving, the overall burden of the tax system on saving would be reduced, thereby encouraging long-run investment and economic growth.

Another way of increasing revenues would be to reduce or eliminate some existing tax subsidies or tax expenditures. Those that create perverse or inefficient incentives should be examined especially closely. An example is the employer-paid portion of health insurance premiums, which is now entirely exempt from taxation. Instead, premium costs above \$150 per month could be included as taxable income in 1983 and indexed thereafter. Besides increasing federal revenues by \$2.6 billion in 1983 and by \$8.0 billion in 1987, this option would be likely to narrow the scope of employer-provided health insurance, prompting people to economize in their use of medical care. Ultimately, this could help curb health-care costs.

Another possibility--and one that could raise still larger revenues--would be to terminate the deductibility of consumer interest payments. This deduction encourages consumers to buy on credit and discourages saving, particularly in times of high inflation. Ending this deduction would yield additional revenues of \$1.2 billion in 1983 and \$9.6 billion in 1987.

CONCLUSION

The prospect of chronic budget deficits long after the recovery is underway is a serious problem. The increased interest rates resulting from such deficits are likely to crowd out private investment and limit long-run growth. The policy options available to improve the budget and economic outlook are not easy.

One option would be to encourage the Federal Reserve to adopt a more expansive monetary policy. This might result in a more vigorous recovery, particularly in sectors hard hit by tight credit conditions. Faster growth would also reduce the federal deficit. But an easing of monetary policy, even moderately, might prolong the time required to achieve price stability and a highly expansionary monetary policy would virtually guarantee accelerating inflation.

A second option is to enact further spending cuts and tax increases (or postpone tax cuts) to reduce the deficit. This would clearly reduce the risk of a conflict between monetary and fiscal policy and the amount of private investment "crowded out." At the same time, however, it would require sacrifices on the part of many Americans that might be particularly onerous for those who have been adversely affected by the recession.