

Statement of Alice M. Rivlin
Director
Congressional Budget Office

before the
Committee on the Budget
U.S. House of Representatives

March 18, 1982

Mr. Chairman, the problem before this Committee is to respond to the threat of huge and chronic budget deficits without adversely affecting the economy and without eliminating those government services regarded as essential. In part, the deficit problem arises from the commitments made to raise the level of defense spending and to reduce the federal tax burden. But the task of reducing the deficits to manageable size is also made difficult by the depressed levels of economic activity, by tight credit conditions, and ironically, by reduced inflation. 1/

My testimony today will cover four topics:

- o The economic outlook;
- o The budget outlook;
- o Some major risks inherent in the Administration's proposals; and
- o Budget options to reduce the deficit.

1/ To aid the Committee in the challenge ahead, the Congressional Budget Office (CBO) submitted to the two Budget Committees in early February our three-part annual report: Part I, The Prospects for Economic Recovery; Part II, Baseline Budget Projections for Fiscal Years 1983-1987; and Part III, Reducing the Federal Deficit: Strategies and Options. Late in February, at the request of the Senate Appropriations Committee, we released a fourth document, An Analysis of the President's Budgetary Proposals for Fiscal Year 1983.

THE ECONOMIC OUTLOOK

Both the Administration and the CBO anticipate an end to the current recession during the first half of this year, followed by a recovery in the second half. For calendar year 1982, the Administration and CBO forecasts are in close agreement (see Table 1). In 1983, however, the Administration's forecast for inflation and growth is more optimistic than the CBO's. The Administration looks for real gross national product (GNP) to expand by 5.2 percent, and for inflation--as measured by the GNP deflator--to fall to a rate of 6.0 percent. The unemployment rate in the Administration's forecast falls to 7.9 percent for the year as a whole, and the three-month Treasury bill rate is expected to average 10.5 percent.

By contrast, the CBO expects real GNP to grow by about 4.4 percent in 1983, and the GNP deflator to rise by about 7.3 percent. The CBO sees short-term interest rates averaging 2-3/4 percentage points higher than does the Administration. The slower economic growth expected by the CBO for 1983 is largely the consequence of higher real rates of interest in its forecast that serve to dampen the recovery in economic activity.

The Administration's economic assumptions for 1984 and beyond are also more optimistic than the CBO's. Compared with the CBO baseline assumptions, the Administration projects higher

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

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

NOTE: The Administration's assumptions include the presumed effects of its new budget initiatives. The CBO economic assumptions are based on estimates of current policy taxes and spending.

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

The Weak Recovery

In the CBO forecast, the recovery is brought about by the large tax cuts and the increase in defense spending, together with somewhat lower interest rates and declining inflation. The recovery is expected to bring a pickup in household demand for durables--particularly for housing and autos--and, in time, a boost to business investment. Nevertheless, the projected recovery is less vigorous than the typical cyclical upswing.

Why the weak recovery? Although the CBO forecast assumes that money aggregates will grow near the upper end of the Federal Reserve's target range, the assumed path for money growth still leaves little room for rapid growth in real economic activity:

- o The Federal Reserve's targets are consistent with nominal GNP growth in the 7 to 11 percent range during the next two years.

- o With inflation expected to be in the 6 to 8 percent range, the growth in real GNP is likely to be restrained relative to historical experience.

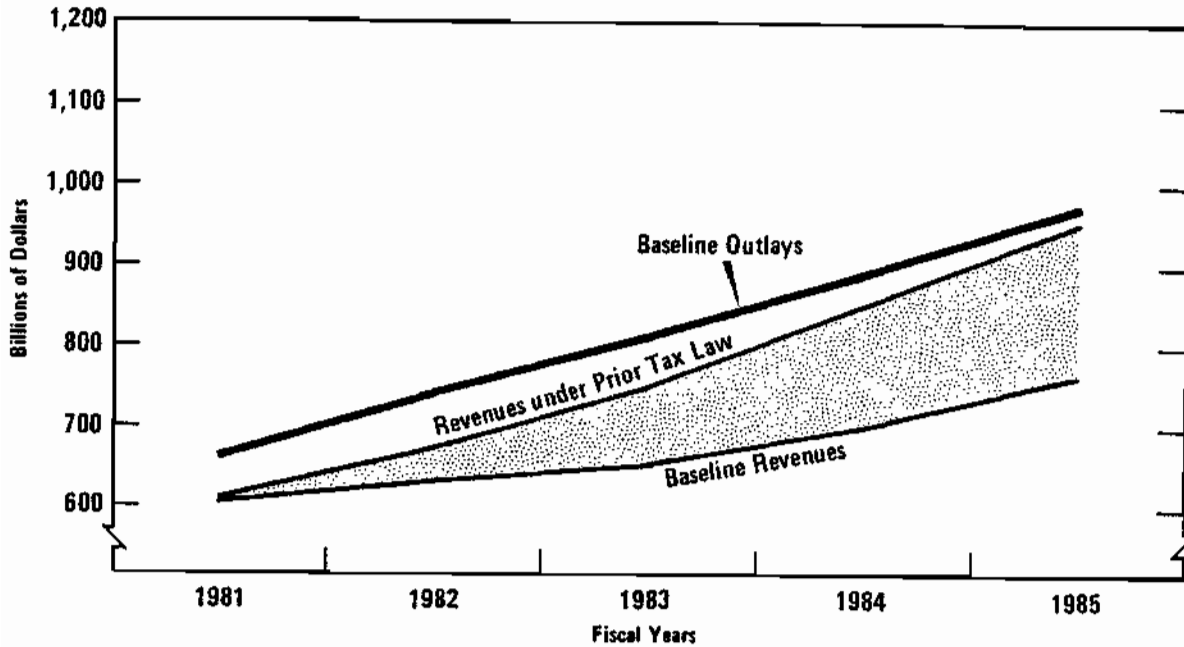
It is possible, of course, that the Federal Reserve will permit more rapid money growth, or that GNP will grow faster than suggested by historical relationships between money and GNP, or that inflation will decline much more rapidly than now seems likely--developments that might be associated with a more vigorous recovery. At present, however, the downside risks appear to be much greater. The major uncertainty relates to interest rates. Some forecasters expect interest rates to climb well above the levels assumed by the CBO, because they anticipate either that the Federal Reserve will pursue a more restrictive policy or that interest rates will be more sensitive to federal deficits than expected by the CBO.

THE BUDGET OUTLOOK

The Budget Outlook Under Current Policies

The budget deficit for fiscal year 1982 is now expected to exceed \$100 billion, almost triple the \$38 billion target set by the Congress in its budget resolutions last year. Most of the increase over that target can be attributed to the current recession. What is unusual, however, is that the recession-induced bulge in the deficit does not disappear once the recession is

Figure 1.
CBO Baseline Budget Projections



SOURCE: Congressional Budget Office.

over. Indeed, although the economy is expected to begin its recovery this year and move into a period of continued growth, budget projections by both the Administration and the CBO show steadily rising deficits under existing tax laws and current spending policies. The reason for the widening gap between baseline revenues and outlays, shown in Figure 1, is clear: The Economic Recovery Tax Act of 1981, which is expected to reduce federal revenues sharply relative to GNP, has not been matched by a corresponding reduction of federal outlays relative to GNP.

The Administration's Budget Proposals

The President's budget includes proposals designed to reduce the federal deficit gradually over the next few years. About 80 percent of their deficit reduction would come from cuts in spending below projected current services levels; only a little more than 20 percent of the deficit reduction would involve revenue increases.

- o The spending cuts proposed by the Administration would affect almost exclusively federal grants to state and local governments and expenditures on the day-to-day domestic operations of the federal government.
- o Nearly 75 percent of the proposed net revenue increases during 1983-1985 would come from higher corporate income taxes, offsetting about 60 percent of the corporate tax reduction enacted in the Economic Recovery Tax Act for that period.

If the President's proposals are adopted, the Administration projects that the deficit will decline from about \$100 billion in 1982 to \$72 billion in 1985.

CBO's Analysis of the President's Budget

The Congressional Budget Office has analyzed the President's February budget and finds that revenues would be slightly lower than estimated by the Administration for 1983-1985 and budget outlays would be substantially higher. This finding results from CBO's technical analysis of the Administration's budget estimates and the substitution of CBO's economic assumptions for the Administration's. As shown in Table 2, the technical reestimates are much larger than the reestimates resulting from economic assumptions.

TABLE 2. CBO BUDGET REESTIMATES (By fiscal year, in billions of dollars)

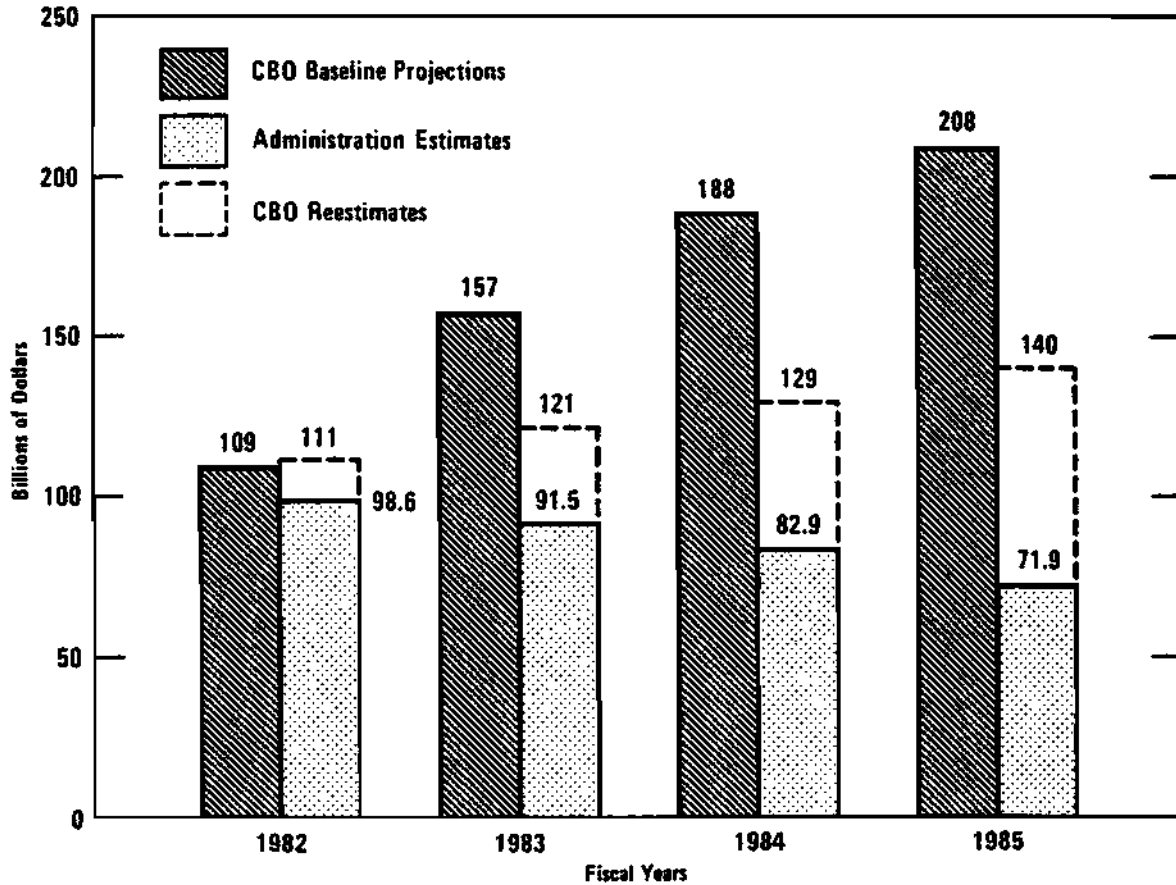
| | 1982 | 1983 | 1984 | 1985 |
|-----------------------------------|------|------|-------|-------|
| Technical Reestimates | | | | |
| Revenues | 4.3 | -5.2 | -13.0 | -15.6 |
| Outlays | 12.2 | 19.9 | 22.1 | 23.0 |
| CBO's Economic Assumptions | | | | |
| Revenues | -3.4 | -0.8 | 5.6 | -4.9 |
| Outlays | 1.2 | 3.2 | 16.4 | 24.2 |

The CBO budget reestimates produce a dramatic change in the outlook for the deficit under the Administration's policy proposals. Instead of declining at a moderate rate, CBO's technical and economic reestimates suggest that the deficit would rise steadily from \$111 billion in 1982 to almost \$140 billion in 1985--almost twice the level projected by the Administration. This result is shown in Table 3 and portrayed graphically in Figure 2.

TABLE 3. UNIFIED BUDGET DEFICITS (By fiscal year, in billions of dollars)

| | 1982 | 1983 | 1984 | 1985 |
|--|-------|-------|-------|-------|
| President's February Budget | 98.6 | 91.5 | 82.9 | 71.9 |
| Deficit with CBO's Technical Reestimates | 106.5 | 116.6 | 118.1 | 110.4 |
| Deficit with CBO's Technical Reestimates and Baseline Economic Assumptions | 111.1 | 120.6 | 128.9 | 139.6 |

Figure 2.
Budget Deficits



The CBO technical reestimates for revenues result mainly from different estimates of the revenue effects of the 1981 tax act. The major CBO technical reestimates for outlays--which are shown in Table 4--involve the cost of farm price supports, which have escalated rapidly in the last few months; likely receipts to

TABLE 4. CBO TECHNICAL OUTLAY REESTIMATES (By fiscal year, in billions of dollars)

| | 1982 | 1983 | 1984 | 1985 |
|-----------------------------------|-------------|-------------|-------------|-------------|
| National Defense | 3.3 | 1.9 | 1.6 | 1.5 |
| Natural Resources and Environment | 0.2 | 0.6 | 0.9 | 0.7 |
| Farm Price Supports | 5.1 | 5.6 | 2.7 | 2.4 |
| Medicare | --- | 0.4 | 1.0 | 1.0 |
| Social Security | 1.0 | 0.9 | 1.2 | -0.2 |
| Other Income Security | 0.5 | 0.8 | 0.7 | 0.8 |
| Net Interest | 0.9 | 3.7 | 8.2 | 13.5 |
| OCS Offsetting Receipts | 0.9 | 5.2 | 4.8 | 3.2 |
| Other (net) | 0.5 | 0.9 | 1.1 | 0.1 |
| Total | 12.2 | 19.9 | 22.1 | 23.0 |

be derived from the Administration's plan to accelerate leasing of Outer Continental Shelf (OCS) lands; net interest costs, mainly for servicing the higher deficit levels that would result from CBO's other technical reestimates; and defense outlays.

SOME MAJOR RISKS

Apart from the CBO reestimates, the Administration's budget proposals entail several additional risks. One is that the Administration may have underpriced its projected defense appropriation requests. CBO has identified two major elements of concern in this regard.

- o First, inflation may not decline as rapidly as assumed for the Administration's budget estimates. With higher than anticipated inflation, the Administration would either have to scale back its planned defense purchases to stay within available funds or seek additional funds to complete the planned purchases. The CBO reestimates of the President's budget did not adjust the Administration's projected budget authority for defense programs for the higher inflation contained in the CBO baseline economic assumptions--that is, the CBO assumed that, in the face of higher inflation, the Administration would not hold to its purchase plans. If this were done, \$61 billion in additional appropriations would be needed during the next five years to achieve the Administration's real growth proposals.

- o Second, the real cost of defense purchases has grown in recent years--averaging about 3-1/2 percent per year since 1975. If the Administration is unable to curb this cost growth, further funds would be needed to meet its defense procurement objectives. If the 3-1/2 percent average annual cost growth continues, for example, CBO estimates that an additional \$48 billion in new budget authority would be required to fund major weapons procurement during 1983-1987.

A second risk is that the Administration may not be successful in meeting all of its targets for revenue increases and outlay savings from various management initiatives. CBO has not been able to develop its own independent estimates for outlay savings from several of these initiatives, particularly those that are clearly targets and are not allocated to specific budget accounts. The unallocated targets for reduction of waste, fraud, and abuse; for improved debt collection; and for the sale of surplus or underused federal property total \$16 billion over the 1983-1985 period. Based on past history, these targets are very optimistic.

A more fundamental risk is the uncertainty in the economic outlook. The Administration's program implies a strong fiscal stimulus in 1982 and 1983. The large budget deficits estimated by the Administration and the even larger deficits projected by the CBO would result in a marked increase in Treasury borrowing that would put further 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.

There is significant risk that the combination of a tight monetary policy and a stimulative fiscal policy could result in even weaker growth than projected by either the Administration or the CBO. Since budget estimates are very sensitive to economic assumptions, policymakers must be prepared for the possibility of dramatically larger budget deficits if the economy fails to perform as well as in the CBO baseline.

BUDGET OPTIONS TO REDUCE THE DEFICIT

Spending-Reduction Options

Given the magnitude of the deficit problem, spending reductions in addition to those proposed by the Administration will probably need to 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. Large potential outlay savings could result from limiting the Administration's proposed real growth in defense spending. According to CBO calculations, the Administration's proposed defense budget includes an average real growth in budget authority of about 6 percent a year over the 1982-1987 period, with an average growth of 9 percent a year in 1982-1985. As shown in Table 5, reducing real growth in budget authority to an average of 3 percent a year over the 1982-1987 period would reduce outlays by \$10 billion in 1983 and \$53 billion in 1987. Although the outlay savings are relatively small in the early years, they become much larger in later years.

TABLE 5. OUTLAY REDUCTIONS FROM REDUCING AVERAGE ANNUAL REAL GROWTH IN BUDGET AUTHORITY (BA) FOR DEFENSE (By fiscal year, in billions of dollars)

| Real Growth in BA | 1983 | 1984 | 1985 | 1986 | 1987 |
|-------------------|------|------|------|------|------|
| 7 Percent | 7 | 9 | 11 | 9 | 1 |
| 5 Percent | 8 | 14 | 22 | 27 | 28 |
| 3 Percent | 10 | 19 | 32 | 44 | 53 |

NOTE: Based on the President's February budget request, after adjustment for CBO technical reestimates and inflation assumptions.

Entitlements. 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 Aid to Families with Dependent Children (AFDC)--which account for less than 20 percent of total outlays for payments to individuals. The rest would occur in non-means-tested programs, including Medicare, federal civilian and military retirement, and railroad retirement, but not Social Security.

Much of the rapid growth in entitlement programs has been in retirement benefits, resulting from automatic cost-of-living adjustments (COLAs). In the last three years, the Consumer Price Index--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 rising home mortgage interest rates. Consequently, the CPI has risen faster than other price indexes during the last five years.

A change in the COLAs 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. Table 6 illustrates the estimated outlay savings from several options.

TABLE 6. ESTIMATED OUTLAY SAVINGS FROM REDUCING COST-OF-LIVING ADJUSTMENTS (COLAs) IN THE FEDERAL RETIREMENT PROGRAMS (By fiscal year, in billions of dollars)

| Option | 1982 | 1983 | 1984 | 1985 |
|---|------|------|------|------|
| Automatic Two-Thirds of COLA with No Discretionary Supplement | 1 | 6 | 10 | 16 |
| Delay COLA Three Months | 3 | 3 | 4 | 4 |
| Skip July 1982/April 1983 COLA | 3 | 14 | 16 | 18 |

NOTE: 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 April 1983.

One potential change would be to skip the July 1982 COLA for Social Security and railroad retirement benefits and the April 1983 COLA for federal civilian and military retirement benefits. If this change were implemented, savings would be \$14 billion in 1983 and \$18 billion in 1985. This approach could also be extended to other indexed programs. If the 1982 COLAs for food stamps and Social Security disability insurance benefits were eliminated, savings in 1983 would amount to about \$1.6 billion dollars in each program.

Revenue-Increasing Options

Revenue-increasing options beyond those proposed in the President's budget could also be considered. Table 7 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 would increase projected revenues by large amounts--more than \$50 billion in 1985, and about \$100 billion in 1987.

TABLE 7. OPTIONS TO INCREASE REVENUES (By fiscal year, in billions of dollars)

| Option | 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 |

Other options 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 more than one-quarter 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 value-added tax could raise as much as \$10 to \$15 billion a year for each percentage point of the tax. If such a tax was 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, especially those that create perverse or inefficient incentives. An example is the employer-paid portion of health insurance premiums, which is now entirely exempt from taxation. Employer contributions to health insurance premiums 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 outlook for the budget is grim. 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 recovery is under way, the recession-induced bulge in the deficit shrinks as tax revenues grow and as outlays for unemployment compensation and related programs decline.

Unfortunately, the budget problem facing the Congress is not recession-related. It is, rather, a problem of continuing large and growing federal deficits into the foreseeable future. No clear economic rationale exists for such deficits. Indeed, the persistence of very large deficits during an economic expansion could seriously impair the overall performance of the economy in

the longer run. Unfortunately, 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 economic 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 too rapid rate of increase in the money supply would virtually guarantee accelerating inflation.

A second option would be 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, with the resulting "crowding out" of private investment. At the same time, however, it would slow the growth of GNP during the recovery period and require sacrifices on the part of many Americans that might be particularly onerous for those who have been adversely affected by the recession.

A third option would be to alter the mix of monetary and fiscal policy somewhat by adopting a somewhat more expansionary monetary policy combined with further spending cuts and tax increases. This might result in lower interest rates and more investment and more vigorous economic growth in the long run.