Statement of
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before the
Committee on Ways and Means
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There should be no release of this statement before its delivery, scheduled for 9:30 a.m., September 25, 1984.

Mr. Chairman, I am pleased to have the opportunity to testify on the economy and the federal budget. My testimony today will be based in part on the recently completed report by the Congressional Budget Office (CBO) on The Economic and Budget Outlook; An Update (August 1984), which you received earlier.

Despite continued high interest rates, record trade deficits, and signs that economic growth is slowing, most forecasters believe the near-term outlook for the economy remains quite good. In contrast, the budget deficit outlook continues to be worrisome, given policies now in place. Although CBO forecasts a decline in the deficit from $195 billion last year to $172 billion in the current fiscal year, our projections also show that under current policies, it would rise steadily to $263 billion in 1989. Deficits of this magnitude would lead to a rising federal debt relative to GNP, which woud put upward pressure on interest rates and imply rapidly escalating debt service costs.

RECENT ECONOMIC DEVELOPMENTS

Recent economic developments have generally been positive. For example, output growth accelerated in the first half of 1984 (Table 1), an unusual development in the second year of recovery. Rapid growth occurred despite a rise in interest rates. Real GNP rose at a 10 percent rate in the first quarter, but decelerated somewhat to a 7 percent rate in the second quarter. Business fixed investment expanded at more than a 20 percent rate, even though real interest rates (interest rates adjusted for inflation) were extraordinarily high. The only major source of weakness in both quarters was net exports, the result of imports rising very sharply in response to the strong growth in the domestic economy and to the very high exchange value of the dollar.

Resources were utilized more fully during the first half of the year. Payroll employment expanded by more than two million, while the unemployment rate fell by a full percentage point. Capacity utilization moved up to 82 percent in the second quarter of the decade, compared to 79 percent in the fourth quarter of last year.

Although economic growth accelerated, inflation continued to be well-behaved. The GNP deflator rose at a rate of 4 percent to 5 percent in the first half of the year, while the Consumer Price Index (CPI) rose at roughly the same rate. That is up slightly from the inflation rate in 1983, but not by much. Moreover, there was little evidence of any of the usual signs of inflationary pressures, such as escalating raw material prices or bottlenecks. In fact, fuel prices have been particularly weak. The continued strength of the dollar has undoubtedly contributed substantially to the low rate of inflation, both by keeping down the prices of imported goods and by exerting competitive pressures on domestically produced goods.

CBO's August forecast anticipated a slowdown in economic growth and recent signs indicate that this is occurring:

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

	1981	1982	1983	1983 I	1983 II	1983 III	1983 IV	1984 I	1984 II
Real GNP	2.5	-2.1	3.7	3.3	9.4	6.8	5.9	10.1	7.1
Final sales	1.5	-0.7	3.2	1.1	6.4	4.9	4.2	3.6	10.3
Consumption	2.0	1.4	4.8	2.6	10.0	3.8	6.8	4.6	7.9
Business fixed investment	5.6	-4.7	2.5	0.0	9.6	18.7	30.6	20.6	21.3
Residential investment	-5.4	-15.0	41.7	64.5	78.1	31.6	4.0	21.3	1.2
Government purchases	1.0	2.0	-0.3	-8.2	-2.6	-.5	-4.3	1.0	18.6
Inventory Change (billions of 1972 dollars)	11.3	-10.4	-3.6	-16.5	-6.1	0.9	7.2	31.6	20.3
Net Exports (billions of 1972 dollars)	43.8	29.7	12.6	22.9	13.6	11.9	2.0	-8.3	-11.4
Industrial Production	2.7	-8.2	6.5	10.0	18.3	22.0	10.0	11.5	8.6
Capacity Utilization (percent)	80.2	72.1	75.3	71.2	73.9	77.3	78.8	80.6	81.6
Payroll Employment (millions)	91.2	89.6	90.1	88.8	89.6	90.4	91.7	92.8	93.8
Civilian Unemployment Rate (percent)	7.6	9.7	9.6	10.4	10.1	9.4	8.5	7.9	7.5
Inflation Rate									
CPI-U	10.4	6.1	3.2	0.3	4.4	4.1	4.5	5.0	3.7
GNP deflator (fixed weight)	9.7	6.4	4.2	3.3	4.1	4.7	3.9	5.0	4.3
Productivity a/	1.4	0.2	3.5	4.4	8.1	2.1	1.0	2.9	4.7
Interest Rates (percent)									
Treasury bill rate	14.0	10.6	8.6	8.1	8.4	9.1	8.8	9.2	9.8
Corporate AAA bond rate	14.2	13.8	12.0	11.8	11.6	12.3	12.4	12.3	13.2

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Board; Moody's Investors' Service.

a/ Output per worker hour, nonfarm business sector.

- The Index of Leading Indicators has declined for two straight months;
- Housing starts have declined for two months in a row—by almost 7 percent in July and by another 13 percent in August;
- New orders for nondefense capital goods declined in June and again in July;
- Retail sales have declined for two consecutive months--by 2 percent in July and by almost 1 percent in August;
- Employment activity appears to have slowed in July and August, although the payroll series and the household survey differ about the extent of the slowing; and
- The Commerce Department's very preliminary "flash" estimate shows real GNP growth slowing to a 3.6 percent annual rate for the third quarter.

THE CBO ECONOMIC PROJECTIONS

The CBO economic projections consist of two parts: (1) the economic forecast for the remainder of 1984 and for 1985, which is contingent on specific assumptions about policy, certain critical raw material prices, and foreign exchange rates; and (2) longer-run projections through 1989, which are based on historical growth trends.

The Forecast for 198* and 1985

The economic forecast is based on the following assumptions:

- Budget outlays are estimated at $845 billion this fiscal year and $929 billion in 1985, reflecting real growth in defense budget authority of 5 percent per year. Revenues are estimated at $673 and $751 billion in fiscal years 1984 and 1985, respectively.
- The growth rate in the monetary aggregates Ml and M2 is assumed to be 6.0 percent and 7.5 percent, respectively, during

the second half of this year. Next year, Ml and M2 are assumed to grow 5.5 percent and 7.25 percent, respectively, at the midpoints of the Federal Reserve's target ranges announced on July 25.

- o The dollar exchange rate is assumed to remain at its average level of the past several months; the price of crude oil to remain near the current level; and food prices to rise about 4 percent this year and about 5 percent next year.

Based on these assumptions, the CBO forecast shows continued growth for the remainder of this year and next, but at a decelerating rate. The rapid expansion in the first half of this year established the strong forward momentum for the economy, but very high levels of interest rates and the maturing of the expansion are expected to slow growth. Output is expected to grow 6.6 percent for the four quarters of 1984 and 2.8 percent next year (see Table 2). Under this the growth forecast, the average unemployment rate would decline to slightly less than 7 percent in 1985, compared to about 7.5 percent this year.

According to CBO projections, inflation will accelerate moderately both this year and next. The Consumer Price Index will rise 4.5 percent this year and 5.2 percent in 1985, compared to 3.3 percent in 1983. The principal reason for this acceleration is that some of the factors holding down the rate of inflation are not expected to continue, notably the appreciation of the dollar and weakness in the prices of crude oil and food raw materials.

Interest rates remain high in the CBO forecast, in part because of the large federal deficits reflected in current policies. The three-month

TABLE 2. THE CBO FORECAST FOR 1984 AND 1985

	Actual		Forecast	
	1982	1983	1984	1985
Fourth Quarter to Fourth Quarter (percent change)				
Nominal GNP	2.7	10.4	10.9	8.2
Real GNP	-1.5	6.3	6.6	2.8
GNP Implicit Price Deflator	4.3	3.8	4.1	5.3
Consumer Price Index, Urban Consumers	4.5	3.3	4.5	5.2
Calendar Year Average (percent)				
Civilian Unemployment Rate	9.7	9.6	7.3	6.7
Three-Month Treasury Bill Rate	10.6	8.6	10.0	9.7
Corporate Bond Rate, Moody's AAA	13.8	12.0	13.1	12.3

Treasury bill rate averages 10.0 percent in 1984 and declines only slightly to 9.7 percent in 1985, despite the substantial slowdown in economic growth. Long-term rates, as measured by the AAA corporate bond rate, average 0.8 percentage points lower next year than this year, in part because the underlying inflation rate continues to be moderate in the forecast.

Projections for 1986 through 1989

The CBO economic projections for 1986 through 1989 are summarized in Table 3. These projections are not necessarily consistent with current budget policies. They simply assume moderate noncyclical growth rates based on historical experience. In the projection, economic growth averages 3.1 percent per year for 1986 through 1989. For the entire seven-year period from the end of 1982 to the end of 1989, the implied annual growth rate is 4 percent--the same as the average for the seven years following the troughs of the first six postwar recessions. Given this kind of growth, the civilian unemployment rate edges down to an average of 6.3 percent in 1988. Projected inflation remains virtually flat for 1986 through 1989, at approximately the rate forecast for 1985. Interest rates decline slightly between 1985 and 1986, and then remain flat for the rest of the projection period. Since inflation is also flat, real interest rates are assumed to be constant.

Uncertainties in the Outlook

The major uncertainties in CBO's forecast center around the behavior of inflation and interest rates over the next 18 months and the response of the economy. Some analysts believe the current economic expansion could be nearing a point where resource constraints will lead to intensified inflationary pressure. Other analysts are concerned that the Federal Reserve has been focusing too much on reducing inflation. Nevertheless,

TABLE 3. MEDIUM-TERM PROJECTIONS FOR CALENDAR YEARS 1986-1989

Economic Variable	Actual 1983	Forecast 1984	Forecast 1985	Projected 1986	Projected 1987	Projected 1988	Projected 1989
GNP (billions of current dollars)	3305	3683	4004	4329	4687	5064	5466
GNP (percent change, year over year)	7.7	11.5	8.7	8.1	8.3	8.0	7.9
Real GNP (percent change, year over year)	3.7	7.3	3.6	3.1	3.3	3.1	3.0
GNP Implicit Price Deflator (percent change, year over year)	3.8	3.9	4.9	4.9	4.8	4.8	4.8
CPI-U (percent change, year over year)	3.2	4.4	5.0	4.9	4.8	4.8	4.8
Civilian Unemployment Rate (percent)	9.6	7.3	6.7	6.6	6.4	6.3	6.3
Three-Month Treasury Bill Rate	8.6	10.0	9.7	8.9	8.9	8.9	8.9
Corporate Bond Rate (Moody's AAA)	12.0	13.1	12.3	11.5	11.5	11.5	11.5
Corporate Profits a/ (percent of GNP)	6.8	7.9	7.9	8.1	8.1	8.0	8.1
Wage and Salary Disbursements (percent of GNP)	50.2	49.2	49.1	49.0	48.9	48.7	48.6
Other Taxable Income b/ (percent of GNP)	19.0	19.7	20.0	20.1	20.1	20.1	20.0

SOURCE: Congressional Budget Office.

a/ Corporate profits with inventory valuation and capital consumption adjustments, on a national income and product accounts basis. To arrive at "book" profits, the basis for tax estimates, these adjustments are removed.

b/ Other taxable income consists of personal interest income, including interest on the public debt, rent, dividends, and income of unincorporated businesses.

with the moderate growth projected by CBO, and in the absence of inflationary shocks that are not now foreseen, changes in the inflation rate in the near-term seem likely to be moderate.

The exchange rate of the dollar presents another but related element of uncertainty. The CBO forecast assumes that strong credit demands and relatively high U.S. interest rates will keep the dollar near its current level, and that we will continue to rely heavily on foreign capital to help finance large federal deficits. A curtailment, however, of net capital inflows--either because of reduced confidence in the United States or enhanced opportunities in other countries--would cause a fall in the dollar's value. That, in turn, would put upward pressure on both domestic inflation and interest rates.

THE BUDGET OUTLOOK

CBO's latest baseline budget projections continue to show rising federal deficits during the next five years, from an estimated $172 billion for 1984 to $178 billion in 1985 and $263 billion by 1989 (see Table 4). These projections take into account recent Congressional action on the Deficit Reduction Act of 1984 and several other budget measures, as well as our current economic forecast and longer-run assumptions. They do not take into account, however, the effects of any enacted 1985 appropriations, but these are not likely to change the outlook significantly.

While still disturbing, the budget outlook has improved during the last six months, largely as the result of legislative action. Last February, CBO projected that, given the spending and taxing policies in place at that time, the federal budget deficit would grow from $189 billion in 1984 to $197 billion in 1985 and to $308 billion by 1989. Our latest baseline projections for the six-year period 1984 through 1989 are cumulatively $166 billion lower. Enacted legislation accounts for $142 billion of this reduction. Revised economic assumptions--largely higher interest rates--add $62 billion for the period, but technical reestimates offset $40 billion of this increase. Together, these legislative, economic, and technical changes yield savings in debt service of $46 billion.

The effect of the legislative action has been to stabilize more-or-less the deficit relative to the size of the economy. As shown in Table 4 and portrayed in Figure 1, baseline deficits are now projected to decline from 4.8 percent in 1984 and then to rise slowly to 4.9 percent by 1989. This contrasts with our February projections of 5.3 percent in 1984, 5.0 percent in 1985, and 5.7 percent in 1989.

These deficits would cause the federal debt held by the public nearly to double from an estimated $1.3 trillion at the end of 1984 to $2.5 trillion by the end of 1989. The ratio of debt to GNP would increase from 36 percent in 1984 to 46 percent by the end of the decade--the highest since the early 1960s (see Figure 1).

The outlook for the level of goverment debt is especially worrisome. Many analysts believe that the stock of debt relative to GNP, rather than the deficit per se, works most directly to affect the level of interest rates,

TABLE 4. CBO BASELINE BUDGET PROJECTIONS
(By fiscal year)

	1983 Actual	1984 Base	Projections 1985	1986	1987	1988	1989
			In Billions of Dollars				
Revenues	601	673	751	811	881	965	1,042
Outlays	796	845	929	1,006	1,097	1,203	1,305
Unified Budget Deficit	195	172	178	195	216	238	263
Off-Budget Deficit	12	11	14	14	15	16	15
Total Deficit	208	183	191	209	231	254	278
			As a Percent of GNP				
Revenues	18.6	18.7	19.1	19.1	19.2	19.4	19.4
Outlays	24.7	23.5	23.7	23.7	23.9	24.2	24.3
Unified Budget Deficit	6.1	4.8	4.5	4.6	4.7	4.8	4.9
Off-Budget Deficit	0.4	0.3	0.3	0.3	0.3	0.3	0.3
Total Deficit	6.4	5.1	4.9	4.9	5.0	5.1	5.2

and through them the level of private investment. The continuing increases in the debt/GNP ratio that are implied by current policy therefore threaten us with persistent upward pressure on interest rates, and the danger that federal borrowing will crowd private investment out of the financial markets. In addition, as a consequence of the growing debt levels, net interest costs are projected to double almost over the next five years--rising from an estimated $111 billion in 1984 to $214 billion in 1989. Net interest costs are now the most rapidly growing item in the federal budget.

As a percentage of GNP, these costs are projected to rise from 3.1 percent in 1984 to 4.0 percent in 1989 (see Figure 1).

Revenue and Outlay Projections

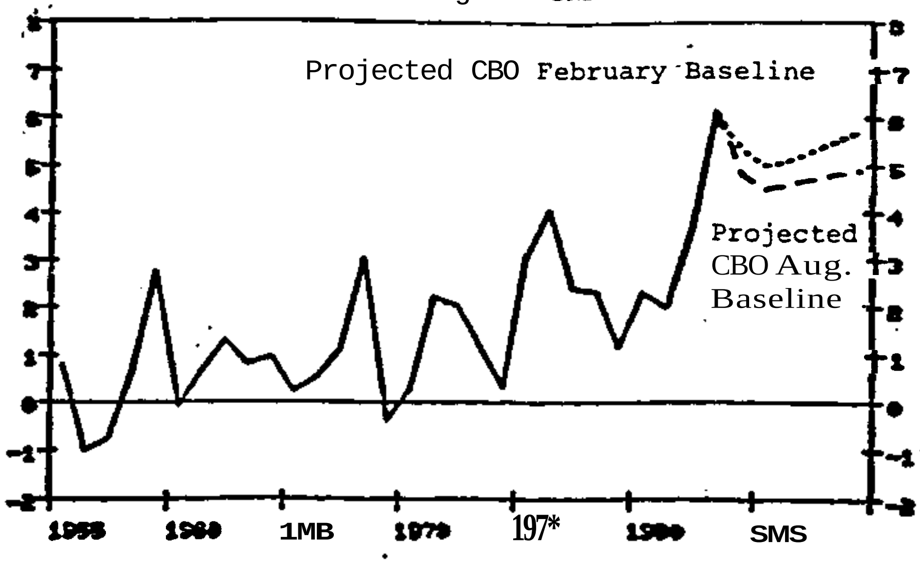
CBO's baseline budget projections are designed to show what would happen to the federal budget if current policies were continued in the future. For revenues and for mandatory spending items, current policies are defined largely by the laws now in effect. For discretionary spending, however, the definition of current policy is not as clear, since appropriations are made for only one year at a time. Because action is still underway on the 1985 appropriation bills, our August projections merely updated our February projections for revised economic and technical assumptions.

CBO projects baseline revenues will rise from $673 billion in 1984 to $751 billion in 1985 and $1,042 billion in 1989. During this period, revenue growth is projected to be somewhat faster than the assumed growth in GNP. Consequently, revenues as a percent of GNP would rise from 18.7 percent in 1984 to 19.1 percent in 1985 and 19.4 percent in 1989.

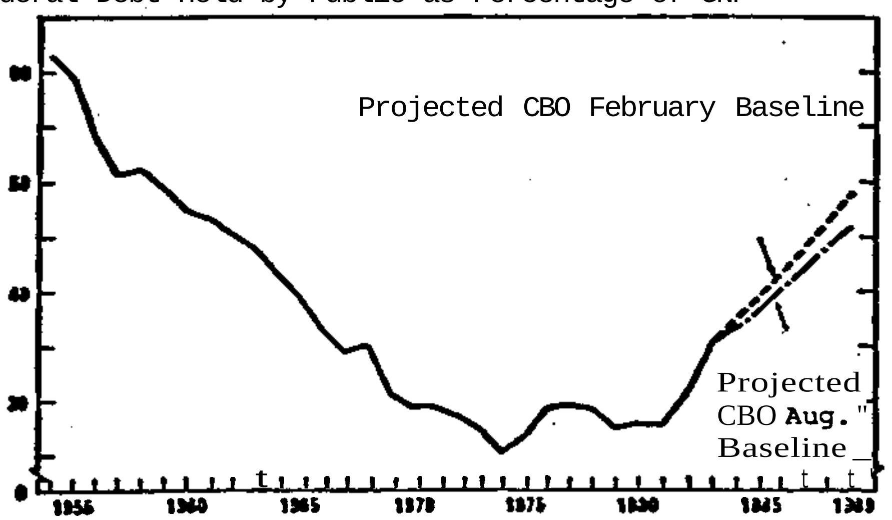
The projected stream of revenues is more than $100 billion higher for the 1984-1989 period than CBO estimated last February. Almost all of the increase can be attributed to the revenue provisions in the Deficit Reduction Act of 1984. Strong economic growth this year has resulted in a higher revenue estimate for 1984, but for 1985 through 1989 economic and technical revisions to our baseline projections are mostly offsetting.

FIGURE 1, SELECTED FISCAL MEASURES, 1955-1983 AND PROJECTIONS FOR 1984-1989 (FISCAL YEARS)

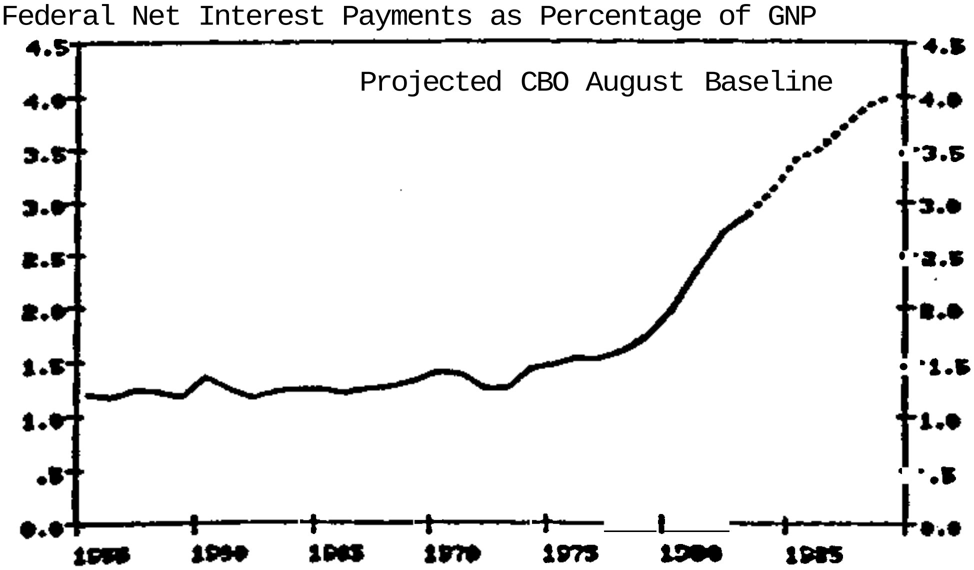
Federal Deficit as a Percentage of GNP



Federal Debt Held by Public as Percentage of GNP



Federal Net Interest Payments as Percentage of GNP



SOURCE: Congressional Budget Office.

Under CBO projections, the composition of federal revenues would change marginally over the next five years. Individual income taxes and social insurance taxes would grow from 80 percent of total revenues in 198* to 83 percent by 1989. Corporation income taxes would increase slightly in relative importance, while excise taxes and other revenues would continue to diminish in importance (see Table 5).

CBO baseline revenues are defined as revenues generated under existing tax law, with the exception of the assumed extension of certain trust fund taxes. CBO assumes that hazardous substance response trust fund (superfund) taxes will be extended at current rates beyond their scheduled expiration date in 1985; airport and airway trust fund taxes beyond 1987; and highway trust fund taxes beyond 1988. These assumed extensions account for $14 billion of CBO baseline revenues in 1989. In other words, if the Congress were to allow these taxes to expire on schedule, 1989 revenues would be $14 billion below the baseline estimates shown here.

Because all other temporary provisions of existing law are assumed for these estimates to expire on schedule, a decision to extend any of these provisions would alter projected baseline revenues. If the Congress were to extend all of these revenue-raising provisions, such as the temporary increases in cigarette and telephone usage excise taxes, while allowing all of the temporary revenue-losing provisions to expire, revenues would be $4 billion above the current baseline estimate by 1989. On the other hand, if the Congress were to extend all of the temporary revenue-losing provisions,

TABLE 5. BASELINE REVENUE AND OUTLAY PROJECTIONS BY SOURCE OR MAJOR CATEGORY (By fiscal year, in billions of dollars)

	1984 Base	Projections 1985	1986	1987	1988	1989
			Revenues by Source			
Individual Income Taxes	302	342	375	411	454	498
Corporate Income Taxes	60	66	73	86	91	96
Social Insurance Taxes	239	268	290	311	345	372
Excise Taxes						
Windfall Profit Taxes	8	7	6	5	4	4
Other	29	32	30	31	31	30
Estate and Gift Taxes	6	6	5	5	5	5
Customs Duties	11	13	13	14	15	15
Miscellaneous Receipts	17	18	19	19	20	21
Total Baseline Revenues	673	751	811	881	965	1,042
			Outlays by Major Category			
National Defense	230	262	293	327	366	406
Entitlements and Other Mandatory Spending						
Social Security	175	185	197	211	227	243
Medicare	62	70	78	88	100	113
Other	158	162	171	178	187	195
Subtotal	396	417	446	477	514	551
Nondefense Discretionary Spending	155	164	171	181	190	199
Net Interest	111	134	150	169	194	214
Offsetting Receipts	-47	-48	-54	-58	-61	-66
Total Baseline Outlays	845	929	1,006	1,097	1,203	1,305

SOURCE: Congressional Budget Office.

while allowing expiration of temporary excise taxes (except the three trust fund taxes, extended in the baseline), 1989 baseline revenue would be $11 billion below the estimate shown here. These temporary provisions and their treatment in the CBO baseline are summarized in the box below.

Baseline outlays are now projected to rise from $845 billion in 1984 to $929 billion in 1985 and $1.3 trillion by 1989. The growth in outlays between 1984 and 1989 averages 9 percent per year, slightly more than the assumed rate of increase in GNP for this period. Consequently, total outlays as a percent of GNP rise from 23.5 percent in 1984 to 24.3 percent in 1989.

CBO's August baseline outlay projections for 1984-1989 are about $60 billion or 1 percent lower than our February estimates. Legislation enacted by the Congress before its July recess reduced outlays by $38 billion for the six-year period; about half of this resulted from the Deficit Reduction Act. Technical reestimates also reduced projected outlays by $25 billion, but revised economic assumptions--largely higher interest rates--increased projected outlays by $50 billion. The effect of these changes in the outlay projections, together with changes in the revenue projections, is to reduce projected deficits by $120 billion for 1984 through 1989. This reduction, in turn, provides additional savings in debt services costs amounting to $46 billion.

Under our baseline assumptions, changes in the compositon of federal spending are more substantial than for revenues. With large and growing

CBO BASELINE TREATMENT OF TEMPORARY REVENUE PROVISIONS

Type of Provision	Expiration Date	Extension Assumed in Baseline
Revenue Raising Provisions		
Trust Funds		
Hazardous Substance (Superfund)	9/30/85	Yes
Airport and Airway	12/31/87	Yes
Highway	9/30/88	Yes
Post Closure Liability	9/30/85	No
Other Excises		
Cigarette	9/30/85	No
Telephone	12/31/87	No
Revenue Losing Provisions		
Energy Tax Incentives	12/31/85	No
Other Tax Incentives		
Research and Development Credit	12/31/85	No
Targeted Jobs Credit	12/31/85	No
Non-Itemizers' Deduction for Charitable Contributions	12/31/86	No
Small Issue IDBs	12/31/86	No
Employee Stock Ownership Plan Credit	12/31/87	No
Six-Month Holding Period for Long-Term Capital Gains	12/31/87	No
Others	12/31/84--12/31/88	No
Net Effect on 1989 Baseline Revenues of		
Provisions Assumed to be Extended		+$14 billion
Provisions Assumed to Expire		+$7 billion

deficits and no reduction in inflation-adjusted interest rates after 1985, net interest costs would nearly double over the next five years. They would rise from 13 percent of total outlays in 1984 to 16 percent by 1989. Assuming a 5 percent annual real growth in defense budget authority (as was done for our February baseline projections), defense spending would also rise as a share of the budget--from 27 percent in 1984 to 31 percent in 1989. While outlays for entitlements and other mandatory spending programs are projected to increase by $155 billion between 1984 and 1989, their portion of the budget would fall from 47 percent to 42 percent. Social Security and Medicare account for three-fourths of the projected increase in entitlements, and about 27 percent of total spending.

Sensitivity of the Budget Projections to Economic Assumptions

Budget estimates are sensitive to relatively small changes in economic assumptions. This can be illustrated by showing the effects of a one percentage-point change in some of the key economic variables, such as real GNP growth or the level of interest rates. This is done in Table 6.

If interest rates are one percentage point higher than assumed for the CBO projections, the baseline budget deficits for 1985 would be higher by $4 billion and for 1989 by $26 billion. On the other hand, if real growth is one percentage point higher than was assumed for the CBO projections throughout the 1985-1989 period, the baseline deficit for 1985 would be $9 billion lower and the 1989 baseline deficit would be reduced by $105 billion.

The results shown in Table 6 should not be interpreted as alternative economic scenarios. Sustained changes in one economic variable do not generally occur without changes in other variables as well. Also, it should be noted that a one percentage-point change in both variables was assumed as a convenience and not to reflect typical forecasting errors. Interest rates tend to be volatile and difficult to forecast, especially in recent years.

TABLE 6. THE EFFECTS ON BASELINE BUDGET PROJECTIONS OF HIGHER REAL GROWTH AND INTEREST RATES (By fiscal year, in billions of dollars)

	1985	1986	1987	1988	1989
Real Growth: Effect of One-Percentage-Point Higher Annual Rate Beginning October 1984					
Change in revenues	8	22	38	56	77
Change in outlays	-1	-4	-9	-17	-28
Change in deficits	-9	-26	-47	-73	-105
Interest Rates: Effect of One-Percentage Point Higher Annual Rates Beginning October 1984					
Change in revenues	1	1	1	1	1
Change in outlays	5	10	15	22	27
Change in deficit	4	10	14	21	26

SOURCE: Congressional Budget Office.

Although real growth rates fluctuate greatly from year to year, they tend to be more stable over five-year periods. Hence, a one percentage-point average error in projecting interest rates is more probable than a one percentage-point error in projecting real growth rates over a long period of time.

CONCLUSIONS

Despite high interest rates, the near-term outlook for the economy is bright. Most forecasters expect the recovery to continue through next year, with only a moderate acceleration in inflation. The high level of the federal deficit, however, remains a serious problem. While the deficit as a percent of GNP has been roughly stabilized, under current policies the debt would grow much more rapidly. That threatens to put persistent upward pressure on interest rates. In addition, servicing that debt promises to become a crushing burden unless policies are changed.