STATEMENT OF

Alice M. Rivlin, Director

Congressional Budget Office

before the

Committee on the Budget

United States Senate

March 11, 1981

There should be no release of this document before its delivery, scheduled for 10:00 a.m., March 11, 1981.

In his February 18 message to the Congress, President Reagan proposed a dramatic change in government policies designed to slow inflation, encourage saving and investment, and stimulate economic growth. President Reagan's plan to achieve these objectives consists of four parts: (1) a sharp reduction in the growth of federal budget outlays beginning in 1982 and continuing for the next four years; (2) substantial federal tax cuts over the next three years; (3) simplification and weeding out of federal regulations that hamper economic activity; and (4) a slower growth in the supply of money.

Mr. Chairman, my testimony today will focus exclusively on the first element of the President's plan--the proposed spending cuts, which the Budget Committee will act upon next week. I understand that you will be asking me to return later in the month to discuss the CBO annual report and other subjects of interest to the Committee as it prepares to mark up the first budget resolution for 1982.

Reagan Administration Spending Proposals

The new Administration's spending proposals represent a radical redirection of the federal budget. The President proposes to reduce sharply the size of the federal budget relative to the total economy, and to change significantly its relative composition. These changes would be achieved by holding the growth of federal outlays during the next three years to less than 6 percent annually, and by increasing the share of the budget allocated to defense spending from 23.4 percent in 1981 to 33.2 percent in 1984. The Administration calculates that total outlays as a percentage of the Gross National Product (GNP) would fall from 23.0 percent in 1981 to 19.3 percent in 1984. As shown in Table 1, the proposed shifts in federal spending trends during the next three years stand in sharp contrast to the trends since 1977.

TABLE 1. FEDERAL SPENDING TRENDS (By fiscal year)

	Actual		Reagan Administration Budgets			
	1977	1980	1981	1982	1983	1984
Budget Outlays (billions of dollars)						
National defense	97.5	135.9	162.1	188.8	226.0	255.6
Nondefense	305.2	443.7	493.1	506.5	506.0	514.6
Total	402.7	579.6	655.2	695.3	732.0	770.2
Relative Composition (percent)						
National defense	24.2	23.4	24.7	27.2	30.9	33.2
Nondefense	75.8	76.6	75.3	72.8	69.1	66.8
Total	100.0	100.0	100.0	100.0	100.0	100.0
Shares of GNP (percent)						
National defense	5.2	5.3	5.7	5.9	6.3	6.4
Nondefense	16.4	17.3	17.3	15.9	14.1	12.9
Total	21.6	22.6	23.0	21.8	20.3	19.3

The President's budget proposals also diverge significantly from those made by the Carter Administration in January. As shown in Table 2, the

Administration budget estimates released yesterday project outlays of $655.2 billion in 1981 and $695.3 billion in 1982. These estimates represent reductions in total outlays of $7.5 billion for 1981 and $44.0 billion for 1982 from the levels recommended by President Carter. Since President Reagan recommends higher defense spending for both 1981 and 1982, the reductions in nondefense programs are even larger than the reductions in total outlays.

TABLE 2. SPENDING PROPOSALS BY THE CARTER AND REAGAN ADMINISTRATIONS FOR FISCAL YEARS 1981 AND 1982 (In billions of dollars)

		1981 Estimate		1982 Estimate	
	1980 Actual	Carter budget	Reagan budget	Carter budget	Reagan budget
National Defense	135.9	161.1	162.1	184.4	188.8
Payments for Individuals	271.2	319.2	317.4	353.4	337.3
Net Interest	52.5	67.0	64.1	74.8	68.2
All Other	120.1	115.5	111.5	126.8	100.9
Total	579.6	662.7	655.2	739.3	695.3

Some of the outlay reductions in the President's budget result from reestimates based on a new set of economic assumptions that projects somewhat lower unemployment, inflation, and interest rates than were assumed for the Carter budget. For example, net interest costs are projected by the Administration to be almost $3 billion lower in 1981 and $6.6 billion lower in 1982 than estimated for the Carter budget. Outlays for unemployment compensation benefits under current law also are now expected to be lower for both years than projected in January--by $0.7 billion in 1981 and by $1.4 billion in 1982. The July 1981 Social Security cost-of-living adjustment (COLA) is now projected to be 11.6 percent (compared with 12.3 percent in the Carter budget), and the July 1982 COLA is projected to be 9.2 percent (compared with 11.3 percent in the Carter budget). Estimated outlays for Social Security and other retirement benefits under existing law have been revised downward accordingly by $0.5 billion in 1981 and by $2.3 billion in 1982.

The bulk of the spending reductions, however, would be achieved by specific program cuts. Many of these have been proposed before by other administrations, and many appeared in CBO's recent report, <u>Reducing the Federal Budget: Strategies and Examples</u>.

The Administration used nine criteria for developing its spending reduction strategy. These included eliminating unintended entitlement benefits, reducing benefits for people with middle to upper incomes, and giving state and local governments greater flexibility in using federal funds through the consolidation of categorical grants programs. The Administration also used a multiyear approach, which I believe is essential for achieving major changes in spending policy.

The Administration exempted selected programs from any spending reductions, including traditional Social Security, Medicare, railroad retirement, unemployment insurance, supplemental security income, and certain veterans' benefits. The Administration estimates that outlays for these programs--referred to as the "social safety net"--will amount to $241.4 billion in 1981, and will rise to $262.6 billion in 1982 and $308.8 billion in 1984. With defense spending also increasing, and net interest costs remaining about the same, the rest of the budget had to bear the brunt of the spending reductions. As shown in Table 3, the Administration proposals would reduce spending in the remaining portion of the budget from $187.6 billion in 1981 to $138 billion in 1984. This would represent a reduction of over 25 percent in current dollars, and 40 percent in real terms using the economic assumptions underlying the Administration budget.

TABLE 3. COMPOSITION OF THE REAGAN ADMINISTRATION BUDGETS FOR FISCAL YEARS 1981-1984 (In billions of dollars)

	Actual	Reagan Administration Budgets			
	1980	1981	1982	1983	1984
National Defense	135.9	162.1	188.8	226.0	255.6
Social Safety Net	205.2	241.4	262.6	286.1	308.8
Net Interest	52.5	64.1	68.2	68.9	67.8
All Other 1/	186.1	187.6	175.7	150.8	138.0
Total	579.6	655.2	695.3	732.0	770.2

1/ For 1983-1984, the estimates assume that budget savings to be identified later will be in the all other category.

The proposed budget cuts fall disproportionately on grants to state and local governments. In 1982, the President's budget recommends \$13.4 billion less in outlays for these grants than proposed by the Carter Administration, accounting for almost one-third of the total decrease from the Carter budget. The major cuts in grant programs for 1982 include the elimination of public service employment programs (for an outlay saving of \$3.5 billion from the Carter budget); the consolidation of various health and social services programs (\$1.8 billion in reduced outlays); the consolidation of state and local education grant programs (\$1.1 billion in estimated outlay savings); and reductions in several benefit payment programs that are administered by state and local governments, such as Medicaid, child nutrition programs, and Aid to Families with Dependent Children (\$3.1 billion in reduced outlays).

Virtually no part of the budget was left untouched by the Administration. Large cuts are proposed for energy programs, food stamps, trade adjustment assistance, transportation programs, and business subsidies. In the Social Security programs, the Administration proposes to eliminate the minimum benefit, to phase out student benefits, and to eliminate certain death benefits. Even in the defense budget, which generally shows large increases, there are proposals to achieve savings through improvements in the procurement procedures and continued restructuring of military bases. (Most of these reductions were also suggested by the CBO in our recent budget reduction report.)

Importance of Making Spending Reductions

Spending reductions of the type proposed by the Administration are essential if major tax cuts are to be made without adding to inflationary pressures, and if the federal budget is to be balanced within the next few years. Major reductions in nondefense programs are also necessary to allow increases for defense spending.

The Administration has not yet identified all of the spending reductions necessary to reach its outlay targets for 1983 and beyond. In order to hold recommended outlays to $770 billion in fiscal year 1984, the Administration will have to specify $44 billion of additional budget cuts. This will not be an easy task.

Without these additional spending cuts, however, the budget would continue in deficit indefinitely and the burden of slowing down inflation would rest solely with the Federal Reserve. Inflationary expectations might be aggravated, and the pressures on credit markets to finance large budget deficits would continue unabated. The success of the Administration program for economic recovery rests heavily on the extent to which the growth in federal spending can be curtailed.

The President's budget targets for 1983 and beyond also depend on achieving both real growth and lower inflation. The economic assumptions used for the Administration budget are optimistic, but not impossible. They rely heavily on new forces, especially the impact of changed expectations on economic activity. Conventional forecasting models would not produce the same results, which the Administration is quick to point out. If the Administration's economic scenario is not attained, however, the consequences for the budget are troubling. Higher inflation, higher interest rates, and higher unemployment would all work to produce more federal spending and larger budget deficits.

Past experience would indicate that inflation might fall at a slower pace than assumed by the Administration. Economists, including the CBO, have tended to underestimate inflation in recent years. The Administration assumptions leave no room for further price shocks for oil and food. Wage demands might not de-escalate as quickly as anticipated. To avoid the risk of being wrong on the outlook for inflation, the Committee might want to consider alternative spending cuts that would reduce the sensitivity of the federal budget to inflation, or to cut more deeply than proposed by the Administration.

Other Budget Reduction Options

One major omission in the Administration's budget proposals is any change in the way benefit payment programs are indexed to inflation, except for making the COLA for federal employee retirement programs once a year rather than twice a year. Of particular concern are Social Security and various federal civilian and veteran retirement programs, which are explicitly indexed to the Consumer Price Index (CPI). These programs will cost over $185 billion in 1981, or close to 30 percent of total federal expenditures. The July 1980 cost-of-living adjustment for Social Security, for example, was 14.3 percent, which alone added $17 billion to fiscal year 1981 outlays. In total, each one-percentage-point increase in the CPI increases federal outlays for indexed benefit programs by about $2 billion a year.

There are a number of reasons why the Congress should consider modifying the indexing of these entitlement programs. First, prices have increased faster than wages during the last several years and therefore beneficiaries of these programs have been more fully protected against the ravages of inflation than have wage earners in general. Second, because of the unusually large weight given to new housing in the CPI, that index has increased faster than the average of all prices faced by the beneficiaries of these programs. Finally, and most importantly, if the rate of inflation comes down more slowly than projected by the Administration, the cost of these programs could be much higher than predicted. This would add further pressure to reduce other spending, and would continue to frustrate movement toward a balanced budget or a smaller federal deficit.

The policy options for modifying the indexing of benefit payments run the gamut from adopting a new index that gives a more representative weight to housing, which was recommended by the Carter Administration, to limiting the annual cost-of-living adjustments to less than the full increase of the CPI--possibly 85 percent of the total increase. Another alternative would be to limit the annual COLA to the lower of the rise in the CPI or a wage index. This latter approach would save an estimated $4.2 billion in 1982 outlays, and $7.2 billion by 1986. With time, however, it would lead to lower real benefits.

Finally, the Congress could make cost-of-living increases less automatic by instituting a procedure like the one now used to adjust white-collar federal pay scales. Each year the President could propose a cost-of-living increase not to exceed the rise in the CPI. The recommendation would take effect unless the Congress acted to alter it. Such a procedure would permit tailoring benefit increases to the current economic situation.

CBO analyzed several other possible budget reductions in its recent report. Those include reducing operating and construction subsidies for the maritime industry, moving toward private financing of the Strategic Petroleum Reserve, providing incentives for hospital cost containment, making general aviation pay its full share of airport costs, and eliminating farm deficiency payments. Such options could be considered in place of or in addition to the President's proposed budget reductions.

Additional Implications of the Administration Proposals

While there are benefits to be gained from reducing the federal share of Gross National Product, there are also costs. The Committee should be aware of several problems as it weighs budget cut proposals: (1) the interrelation of program costs, (2) the cumulative effects on individuals, (3) other unintended impacts of budget cuts, and (4) the overall impact on state and local governments.

Interrelation of Program Costs. Budget cuts in some programs affect spending in other programs. These effects are often difficult to quantify, especially when cuts are made in various programs simultaneously. For example, eliminating public service employment (PSE) jobs would increase spending for public assistance and food stamps and would decrease revenues from Social Security payroll taxes and federal income taxes. Preliminary estimates indicate that federal spending for public assistance and food stamps might increase by 3 to 5 percent of the total PSE cost; federal taxes might decrease by 6 to 10 percent of the total PSE cost. Estimates of the effect on outlays for unemployment insurance are not yet available.

Secondary program effects can also work in the other direction, however. Restrictions on AFDC eligibility can reduce Medicaid outlays. As an example, removing a welfare mother with three children from AFDC eligibility would reduce federal outlays for Medicaid by about $1,000 a year. If the Administration proposal for limiting Medicaid expenditures were adopted, this secondary effect would disappear.

Cumulative Effects. Many people would be affected by more than one program cutback, raising the possibility that some would experience substantial reductions in their total benefits. For example, a welfare mother of three with relatively high work-related expenses could find cuts in AFDC, food stamps, and child nutrition benefits reducing her post-tax post-transfer income by 10 to 20 percent. In addition, she might experience cuts in Medicaid, other health services, and social services provided through federal grants to states. Our capability to quantify these cumulative effects is restricted because of data limitations and the unpredictability of how states would respond to grant consolidations and funding cutbacks.

Unintended Effects. Some program reductions may have unintended effects that must be weighed against gains such as reduced federal spending. For example, some of the changes in AFDC and food stamps tend to make jobs less financially rewarding. Reducing deductions for work-related expenses and counting the earned income tax credit as income in calculating AFDC benefits would reduce the net gains in spendable income obtained from working.

Effects on State and Local Governments. As I noted earlier, the cuts proposed by the Administration would fall disproportionately on grants to state and local governments. State and local governments would respond to these cuts as they have to previous ones--by increasing taxes, reducing budget surpluses, or reducing services. Those jurisdictions with limited tax bases or high tax rates might be least likely to raise additional revenues and most likely to lower services. The Congress could partially offset the effects of grant reductions by increasing the share of assistance received by the most pressed jurisdictions through altered fund allocation formulas for remaining programs, such as Community Development Block Grants and General Revenue Sharing. Spending cuts might also be partially offset for all jurisdictions by reducing administrative requirements in remaining programs, as the Administration has proposed doing by consolidating grants for education and for health and social services.

Conclusion

The Budget Committees and the entire Congress have struggled valiantly to curtail the growth in federal spending and to achieve a balanced budget. It is very hard, however, to undo or modify one by one the steps that have led to greater spending. The Administration has proposed a bold plan for reducing spending growth and redirecting budget priorities. The reconciliation process offers a unique opportunity for achieving substantial multiyear budgetary savings.

A major risk to achieving the spending targets proposed by the Administration is that inflation may not unwind as quickly as anticipated. This would cause spending for indexed benefit programs and the procurement of defense weapons systems to rise considerably faster than projected. To avoid this risk, the Committee may want to consider changes in the way entitlement programs are adjusted for inflation and additional spending cuts. The Congressional Budget Office stands ready to assist this Committee in any way that we can as you begin next week to translate the President's proposals into a plan of action for the Congress.