Statement of
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Mr. Chairman, I am pleased to have the opportunity to testify on the economic and budgetary outlook. As you know, economic conditions have improved greatly since the end of last year. The economic recovery is proceeding at a rapid pace, about in line with past recoveries. Unemployment has already declined substantially, though it remains high. Inflation was greatly reduced during the recession and, while it has not declined further in recent months, the recovery has not generated any significant acceleration in the rate of price increases. The near-term economic outlook also looks favorable. Although economic growth is not likely to proceed at the brisk pace of the last two quarters, most forecasters expect substantial growth next year.

The horizon is clouded, however, largely because the federal deficit situation has not yet been dealt with decisively. The first budget resolution for fiscal year 1984 did take an important step toward reducing future structural deficits. But the resolution has not yet been fully implemented, and as a result many fear that deficits will not decline significantly as the recovery proceeds.

In a report issued last August entitled The Economic and Budget Outlook: An Update, the Congressional Budget Office (CBO) provided this committee with revised economic and budget estimates based upon the policies of the first resolution. My testimony today will summarize and update that report and comment on the risk that may arise if the Congress and the Administration fail to implement the policies of the resolution.

Recent Economic Developments

Although economic growth was weak in the first quarter following the November 1982 recession trough, the recovery has since been vigorous. Gross national product (GNP) increased at an average rate of 8.8 percent in the last half year and industrial production increased at a 20 percent annual rate (see Table 1). As a result, the unemployment rate has dropped sharply from 10.7 percent in December of last year to 9.1 percent in the latest month. In terms of aggregate growth, the recovery now appears to be proceeding at a rate near the average of other recoveries since World War II (see Figure 1 at the end of this statement). At the same time, inflation rates remain very moderate relative to the high rate of the past several years. In the last half year the GNP fixed-weight deflator, a broad measure of price behavior, has increased at about a 4 percent rate, only slightly higher than the low point in inflation last winter. While inflation certainly has not been cured, the improvement since 1980 and 1981 has been dramatic.

In one respect, however, this recovery is not typical. As shown in Figure 2, interest rates remained at remarkably high levels in the recession and thus far in the recovery. Interest rates also appear to have remained high in real terms (that is, adjusted for inflation). Most analysts believe that the very large increase in the actual and projected deficits has contributed to the high rates. The federal deficit was about 107 percent of net private saving during fiscal year 1983, a record for the postwar period.

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

	1981	1982	1982 Q3	1982 Q4	1983 Q1	1983 Q2	1983 Q3
Real GNP	2.6	-1.9	-1.0	-1.3	2.6	9.7	7.9
Final sales	1.8	-0.7	-1.5	4.5	0.6	6.8	5.1
Consumption	2.7	1.4	0.9	3.6	2.9	10.0	3.5
Business fixed investment	5.2	-4.7	-8.8	-6.6	-1.5	7.9	14.6
Residential investment	-5.2	-15.4	-13.0	53.2	57.3	79.5	37.0
Government purchases	0.8	1.8	9.4	10.6	-8.8	-1.1	5.6
Inventory Change (billions of 1972 dollars)	8.5	-9.4	-1.3	-22.7	-15.4	-5.4	4.8
Net Exports (billions of 1972 dollars)	43.0	28.9	24.0	23.0	20.5	12.3	8.7
Industrial Production	2.6	-8.1	-3.4	-8.1	9.8	18.4	21.2
Payroll Employment (millions)	91.2	89.6	89.3	88.8	88.8	89.5	90.1
Civilian Unemployment Rate (percent)	7.6	9.7	10.0	10.7	10.4	10.1	9.4
Inflation Rate							
CPI-U	10.6	6.1	7.7	1.9	-0.4	4.3	n.a.
GNP deflator (fixed weight)	9.5	6.4	5.9	4.7	3.4	4.3	4.1
Interest Rates (percent)							
Treasury bill rate	14.0	10.6	9.3	7.9	8.1	8.4	9.1
Corporate AAA bond rate	14.2	13.8	13.8	11.9	11.8	11.6	12.3

Of course, deficits increase automatically in recessions and this is thought to retard the fall in economic activity. But in 1983 there was a sharp rise in the structural deficit—that is, the deficit that would be experienced at high levels of employment. (The standardized employment deficit rose from 0.9 percent to 2.8 percent of potential GNP.) It is this increase in the structural deficit that is worrisome.

Attempting an explanation of the evolution of economic activity this early in the recovery is somewhat risky. Certain patterns are emerging, however, that may give us some insights into the crowding-out effects of high interest rates resulting from unusually high deficits.

Thus far, business fixed capital formation is following a normal cyclical pattern and does not seem to be adversely affected by the high level of interest rates (see Figure 3). This might suggest that the negative impact of high real interest rates on investment is being offset by the favorable effects of the tax acts of 1981 and 1982, the Economic Recovery Tax Act (ERTA) and the Tax Equity and Fiscal Responsibility Act (TEFRA). Housing has also recovered at a normal rate, even though owner-occupied housing received little in tax benefits. However, the housing industry started at such a low trough that residential investment still constitutes an unusually low share of GNP for this stage of the business cycle (see Figure 4). In addition, inventory investment, which is very cyclical and sensitive to high interest rates, is at a particularly low level (see Figure 5).

Net exports have moved adversely to an extreme degree (see Figure 5). This implies that a significant portion of the budget deficit is being financed, directly and indirectly, by foreign capital inflows. High real interest rates here and political and economic uncertainties abroad are making the United States a relatively attractive place to invest. Foreigners must acquire dollars to purchase U.S. securities and in doing so they bid up the exchange value of the dollar. This makes it harder for our export industries to compete abroad and for our domestic industries to compete with imports. In other words, our trading industries are bearing a significant portion of the crowding-out effect.

The CBO Forecast

The CBO August forecast, made under the assumption that the first budget resolution would be implemented, shows real GNP growing at a rate of 3.1 percent in the current calendar year and 5 percent in 1984 (see Table 2). The unemployment rate is projected to decline to 8.9 percent by the end of 1983 and to 8.2 percent during 1984. Prices, as measured by the GNP deflator, are projected to rise by 4.5 percent this year and by 4.8 percent in 1984. The small temporary increase in inflation next year results from increases in social security taxes and an assumed decline in the value of the dollar in international exchange markets, as well as the tightening of labor

TABLE 2. THE ECONOMIC OUTLOOK (By calendar year)

Economic Variable	1983	1984	1985	1986
GNP (billions of current dollars)				
CBO	3,313	3,644	3,972	4,307
First budget resolution	3,292	3,621	3,948	4,269
Real GNP (percent change, year over year)				
CBO	3.1	5.0	4.0	3.5
First budget resolution	2.8	5.1	4.1	3.7
GNP Implicit Price Deflator (percent change, year over year)				
CBO	4.5	4.8	4.8	4.8
First budget resolution	4.7	4.6	4.7	4.3
CPI-U (percent change, year over year)				
CBO	3.2	4.7	4.7	4.7
First budget resolution	3.5	5.0	4.7	4.1
Unemployment Rate (percent, annual average)				
CBO	9.7	8.4	7.9	7.5
First budget resolution	10.1	9.3	8.5	7.9
3-Month Treasury Bill Rate (percent, annual average)				
CBO	8.8	8.6	7.7	7.4
First budget resolution	7.8	7.4	7.2	6.6

markets and the restoration of profit margins. Treasury bill rates are projected to average about 8.6 percent in 1984 and to decline to 7.7 percent in 1985 and to 7.4 percent in 1986.

The CBO projections beyond 1984 are not a forecast; rather, we make noncyclical projections that assume that the economy moves gradually

toward higher employment levels. Nominal GNP growth is assumed to decline in line with reduced money growth. With no price shocks and a trend productivity growth of 1½ percent per year, this would permit real GNP growth of 4 percent in 1985 and 3½ percent in 1986. This projection implies that the recovery will last longer than most other postwar recoveries, despite considerable uncertainty over monetary and fiscal policy.

The economic information that has become available since this forecast was prepared in early August is consistent with the short-term story told in the forecast. Real GNP, prices, and unemployment seem likely to be very close to the 1983 figures published in the report. Both consumption and federal spending in the third quarter came in a little lower than CBO had expected, but inventory investment and investment in producers' durable equipment were a little stronger than anticipated. Some interest rates have fallen a little faster than expected. But the main lines of the economic situation are much as expected in early August, and there is no reason to change the forecast.

CBO Budget Estimates

Assuming the policies of the first budget resolution for 1984, CBO estimates that the unified budget deficit would decline from slightly below $200 billion in 1983 to about $140 billion in 1986. Relative to GNP, the deficit would decline even faster--from 6.4 percent in 1983 to 3.3 percent in 1986. Even with these projected declines, the deficit in 1986 would still be

very large by historical standards, whether measured in dollar terms or relative to GNP.

These budget estimates incorporate the CBO August economic forecast, certain completed Congressional action on budget items, and various technical reestimates. They differ slightly from those contained in the CBO August report because of additional Congressional action and some new technical reestimates for outlays. The latest CBO budget estimates are compared to the 1984 budget resolution targets in Table 3.

The most striking change from the August CBO budget estimates is the lower deficit for fiscal year 1983. Although the Administration has not yet released the final figures, we expect the 1983 deficit to be $198 billion or less--over $9 billion lower than CBO projected two months ago. Our revenue estimates for 1983 appear to have been on target, but outlays were lower than expected. Defense and farm price supports appear to be the major areas in which 1983 outlays were lower than CBO estimated in August.

As a consequence of the expected 1983 results, we have lowered our outlay estimates for 1984-1986 by about $5 billion for each year, primarily for defense spending and net interest costs. The CBO estimates shown in Table 3 also include the recent Congressional action extending federal supplemental compensation benefits for the long-term unemployed through March 1985.

TABLE 3. COMPARISON OF FIRST BUDGET RESOLUTION TARGETS AND CBO BUDGET ESTIMATES (By fiscal year, in billions of dollars)

Budget Aggregates	1983	1984	1985	1986
Resolution Including Reserve Fund a/				
Revenues				
First budget resolution	604	680	750	836
CBO estimates	600	677	748	842
Outlays				
First budget resolution	813	859	912	967
CBO estimates	798	865	925	984
Deficit				
First budget resolution	209	179	161	131
CBO estimates	198	188	177	142
Resolution Excluding Reserve Fund				
Revenues				
First budget resolution	604	680	750	836
CBO estimates	600	677	748	842
Outlays				
First budget resolution	807	850	907	963
CBO estimates	798	858	921	981
Deficit				
First budget resolution	203	170	156	127
CBO estimates	198	181	173	139

a/ Reserve for new initiatives in domestic spending programs.

TABLE 4. CBO REESTIMATES OF THE BUDGET RESOLUTION DEFICIT TARGETS FOR 1984-1986 (Increases by fiscal year, in billions of dollars) a/

Source of Reestimate	1984	1985	1986	Cumulative Three-Year Total	Percent Distribution
CBO Economic Assumptions	4.1	7.7	4.3	16.2	46
Congressional Action	3.3	2.7	1.2	7.1	20
CBO Technical Reestimate	1.2	5.4	5.2	11.8	34
Total	8.6	15.8	10.7	35.1	100

a/ Budget resolution deficit targets including reserve fund.

The latest CBO reestimates of the budget resolution policies add to the budget deficits for 1984-1986 by a total of $35 billion over the three years. Table 4 summarizes the reasons for the CBO reestimates, which are explained in more detail in the CBO August report. Almost one-half of the upward CBO reestimates of the deficits for 1984-1986 may be attributed to revised economic assumptions. The effects of higher interest rate assumptions more than offset the effects of higher growth and lower unemployment in the CBO August forecast. 1/

1/ For more details, see Congressional Budget Office, The Economic and Budget Outlook: An Update (August 1983), Table 24, page 94.

Twenty percent of the upward deficit reestimates for 1984-1986 may be attributed to Congressional action since the adoption of the first budget resolution. Most of this action relates to revenues: the loss of revenues resulting from the repeal of interest and dividend income withholding was only partially offset by the Railroad Retirement Act Amendments. 2/ The recent extension of supplemental unemployment benefits also adds close to $3 billion to the deficit reestimates because the estimated cost of this legislation exceeds the amount included in the reserve fund for this program.

The remaining one-third of the CBO reestimates of the deficit targets for 1984-1986 result from various technical reestimates of the effects of the resolution policies. The technical reestimates for outlays are mostly offsetting and have little impact on the deficit reestimates. Most of the technical reestimates of the deficits stem from lower revenue estimates, mainly revised estimates of the revenue losses resulting from the liberalized savings incentives enacted as part of ERTA.

The CBO budget estimates presented in Table 3 assume that the reconciliation instructions contained in the first resolution will be fulfilled. While this appears likely for the spending reductions, the $73 billion of revenue increases for 1984-1986 may not be enacted this year. CBO estimates that the Tax Reform Act of 1983 (H.R. 4170), reported last week

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2/ Ibid., Table 25, p. 95.

TABLE 5. POSSIBLE DEFICITS FOR 1984-1986 (By fiscal year, in billions of dollars)

	1984	1985	1986
First Budget Resolution Including Reserve Fund	179	161	131
CBO Reestimates (Table 4)	9	16	11
Difference Between First Resolution's Revenue Assumptions and Enactment of Revenue Provisions of H.R. 4170 as Reported	11	14	44
No Further Action on Remaining Reserve Fund Items	-7	-3	-2
Net Interest Impact	--	1	3
Resulting Deficits	192	189	187

by the Ways and Means Committee, would raise revenues above the baseline by only $4 billion to $5 billion. If the reported version of H.R. 4170 is enacted, the cumulative effect would be to add $69 billion to the projected deficits for 1984-1986. These deficit additions would be only slightly offset by not enacting the authorizations for several new initiatives for domestic spending covered by the resolution reserve fund. The net effect of enacting H.R. 4170 as reported and not proceeding on the remaining reserve fund items, including the impact on net interest costs, would, under static assumptions, be to keep the budget deficit at about $190 billion for the next three years, as shown in Table 5.

Consequences of High Deficits

Although budget deficits would decline substantially if the policies of the first resolution were implemented, the deficits would still be high and would add to interest rate pressures. Nevertheless, CBO expects interest rates to decline gradually, in part because of the large absolute decline in the actual deficit that is consistent with the resolution. The structural deficit would also decline modestly. (The standardized-employment budget deficit would decline from 2.8 percent of potential GNP in fiscal year 1983 to 2.0 percent in fiscal year 1986.) But if the resolution or similar policies are not implemented and deficits remain in the $200 billion range, interest rate pressures could become more intense as private credit demands grow later in the recovery.

The risks associated with the deficit are hard to assess because the ratio of the deficit to GNP will be far higher for a sustained period than anything experienced since World War II. When policy variables move outside of the range of historical experience, analysts can no longer assume with confidence that empirical relationships estimated on the basis of past data will remain relevant to analyses of the current situation.

As a result, there are numerous uncertainties and risks. For example, as the recovery continues, business capital formation may experience more crowding out than has occurred thus far in the cycle. The potential for economic growth will then be reduced, and standards of living will be lowered in the long run. Conversely, growing capital inflows from abroad may offset to some extent the reduction in U.S. capital formation, but this

implies a growing commitment to pay interest and dividends to foreigners, which likewise will reduce future U.S. living standards.

Heavy reliance on foreign capital also leaves the United States vulnerable to changes in the psychology of foreign investors. If, for one reason or another, confidence in the U.S. economy falls and foreign capital inflows are reduced, real interest rates will rise, all else equal, so that the crowding out of U.S. capital formation would be intensified. In addition, higher real interest rates would aggravate the already fragile debt situation in the developing countries.

While controversy will undoubtedly continue regarding the magnitude of the risks described above, one effect of large deficits is almost inevitable: the net interest bill on the national debt will grow and grow. Table 6 shows the net interest bill consistent with the first budget resolution. It grows by $39 billion between fiscal years 1982 and 1986 or by 84 percent of the tax increase scheduled for the latter year. If instead we move along the deficit path shown in Table 5, while assuming that interest rates remain constant at the levels of September 1983, the net interest bill would rise by $56 billion between 1982 and 1986 or $17 billion more than projected for the resolution. A further one-percentage-point rise in interest rates would raise the 1986 net interest bill by still another $14 billion. Thus large current deficits would limit future spending options. More important, large current deficits have a way of generating increased future deficits. At the extreme, interest rates would rise sharply and the impact on the private sector together with the cost of financing the U.S. debt would

TABLE 6. COMPOSITION OF FEDERAL OUTLAYS (By fiscal year) a/

	1980	1982	1984	1986
	In Billions of Dollars			
National Defense	136	187	237	294
Entitlements and Other Mandatory Spending				
Social Security	116	153	177	201
Medicare	34	50	65	82
Other	117	142	147	156
Nondefense Discretionary Spending	141	137	166	167
Net Interest	52	85	105	123
Offsetting Receipts	-20	-24	-32	-40
Total	577	728	865	984
	As a Percent of GNP			
National Defense	5.3	6.1	6.6	7.0
Entitlements and Other Mandatory Spending				
Social Security	4.5	5.0	5.0	4.8
Medicare	1.3	1.6	1.8	1.9
Other	4.6	4.6	4.1	3.7
Nondefense Discretionary Spending	5.5	4.5	4.7	4.0
Net Interest	2.0	2.8	2.9	2.9
Offsetting Receipts	-0.8	-0.8	-0.9	-0.9
Total	22.4	23.9	24.3	23.3
Reference: GNP ($ billions)	2573	3054	3562	4222

a/ Estimates for 1984 and 1986 are based on the policies of the first budget resolution for 1984 including the reserve fund.

become so burdensome that some would urge that the Federal Reserve absorb the deficits in order to avoid the necessary budgetary actions to reduce the debt burden. But if the Federal Reserve succumbed to such pressures--and Chairman Volcker has strongly stated that it will not--the money stock would grow rapidly and sharply higher inflation would follow, eventually leading to another cyclical downturn.

Major Options for Reducing the Deficit

While large deficits may create major risks, abrupt or poorly designed measures to reduce deficits can also be a threat to economic efficiency and to the health of the economic recovery. Major spending cuts and tax changes must occur gradually or with long advance notice so that individuals and firms dependent on current tax and spending policies have time to adjust. Obviously, those affected must have some confidence that the changes will not be reversed at the last minute or soon after they have been implemented. The first budget resolution attempted to invoke such a "gradualist" strategy by putting off major tax increases until 1986.

Any analysis of the potential for reducing deficits in a major way by cutting spending must start with the fact that a very large portion of federal outlays is devoted to very few budget categories, as is shown in Table 6. Defense, entitlements, and net interest constituted 79 percent of outlays in 1980, and the proportion is projected to grow to 87 percent by 1986. In turn, social security and medicare constituted 56 percent of entitlements in 1980, growing to 64 percent by 1986. Note that by 1986,

defense, social security, medicare, and net interest will absorb almost 90 percent of revenues if tax action is confined to H.R. 4170. The possibility of cutting other programs should not be ignored, but since they have already been cut significantly, it is hard to imagine further substantial cuts in total spending without major changes in defense, social security, or medicare.

If such changes are deemed desirable, they should be undertaken quickly. Cuts in defense procurement show up in reduced outlays only after a long time lag. Cuts in social security and medicare ought to be undertaken gradually so that recipients have time to adjust.

One option discussed recently by some members of the Congress is to reduce the automatic cost-of-living adjustments for social security and other indexed benefit programs by some amount--say, two percentage points. This would have a relatively small impact on beneficiaries' income during the first few years, but the cumulative effects over an extended period could be important. If this option is undertaken, the benefit formula for new retirees should also be altered or else inequities will develop between older retirees and those retiring within the next few years.

Spending for medicare and medicaid has been growing rapidly, largely because of rising hospital costs. Major savings in these programs would require reductions in payments to health care providers, curtailment of services covered, or further cost sharing by beneficiaries. Because of the impending financing problem for the hospital insurance trust fund, the Congress in any event will have to make some major changes in the medicare program in the next few years.

Attention will continue to be focused on the nondefense discretionary programs as a source of savings, but the likely reductions in this area will not suffice in themselves to balance the budget.

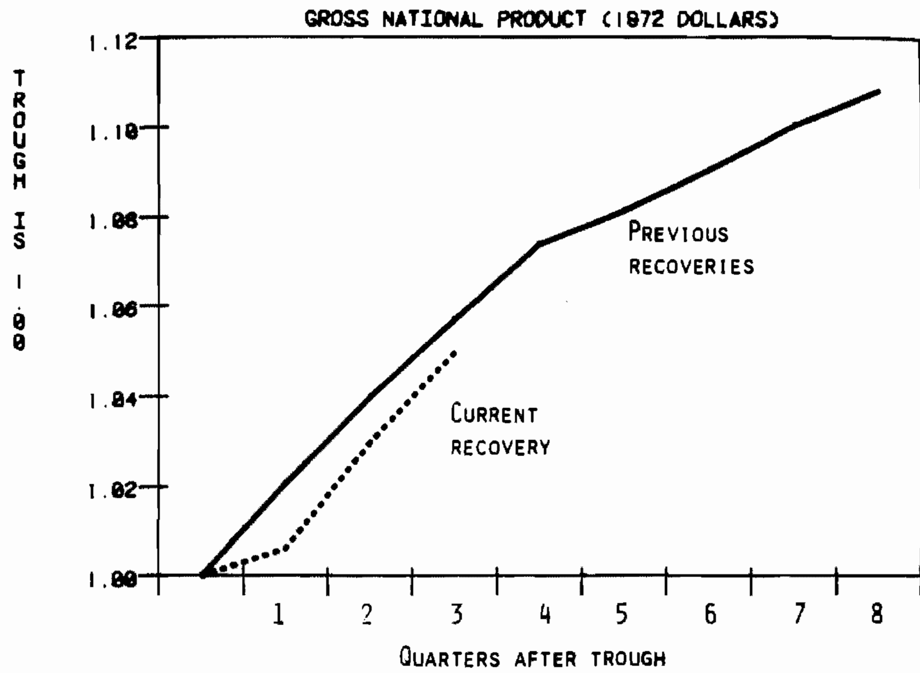
CBO has started its annual review of possible options and strategies for reducing spending, and will present the results to this committee within a few months. In this review, we will be taking a close look at the Grace Commission recommendations, some of which have been considered in earlier CBO analyses.

On the revenue side, there are basically three options: to raise tax rates, to broaden the base of existing taxes, or to introduce new taxes. The first option would be to raise rates under the existing corporate and personal income tax system--for example, by means of a surtax raising rates across the board, or by modifying the indexing of the personal tax rate structure. These options are simple and could raise substantial revenue, but they would mean an increase in marginal tax rates on the current tax base, which would magnify existing inequities and inefficiencies in the tax system.

Broadening the base of existing taxes would hold marginal tax rates down and so might reduce some of the current distortions in the tax system, making taxes more equitable and simple in the eyes of taxpayers. But the transition to a broader-based tax system could be disruptive for particular groups or sectors of the economy that have made plans based upon present tax laws. Moreover, in order to raise sufficient revenues, activities that the Congress has in the past deemed to have special social significance--such as health care and homeownership--would have to be reconsidered.

Finally, introducing new taxes on consumption could raise substantial revenue. A proportional tax on consumption could take the form of a national sales tax or a value-added tax. An excise tax on oil, such as that proposed by the Administration on a contingency basis last January, could also be considered, as could a fee confined to imported oil. The advantage of such taxes is that they would encourage saving and the conservation of oil. However, consumption taxes might have an adverse effect on prices, at least temporarily. Many also object that the burden of such taxes may fall less on high-income individuals than on lower-income groups, but if this is deemed a problem, it could be approximately offset by modifications in the personal income tax and welfare system.

Figure 1. Recovery is near average of post-war recoveries.



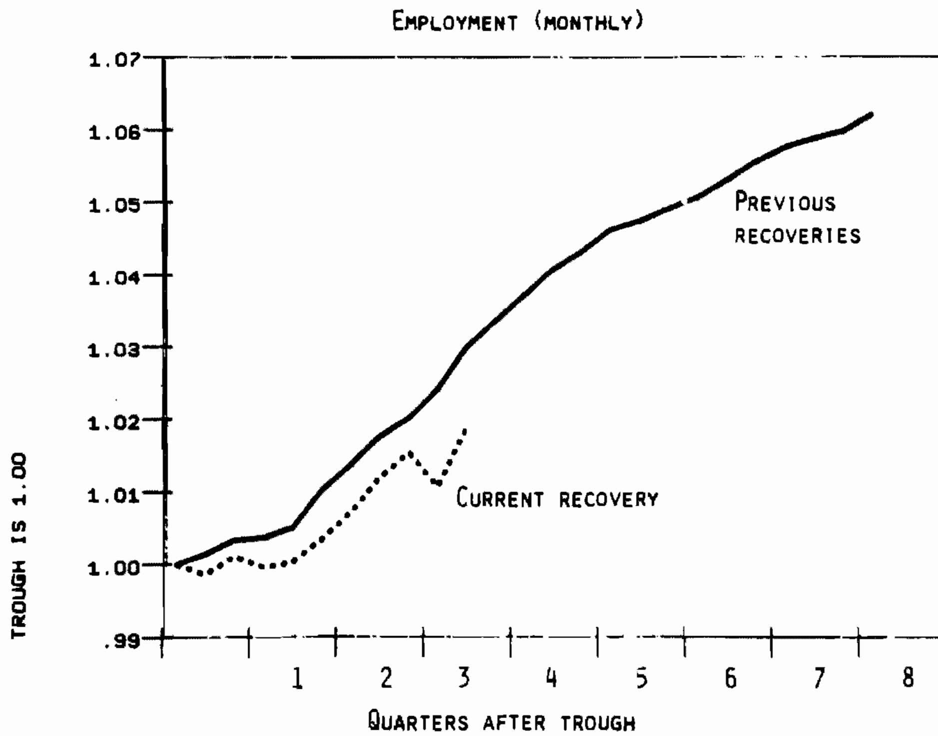
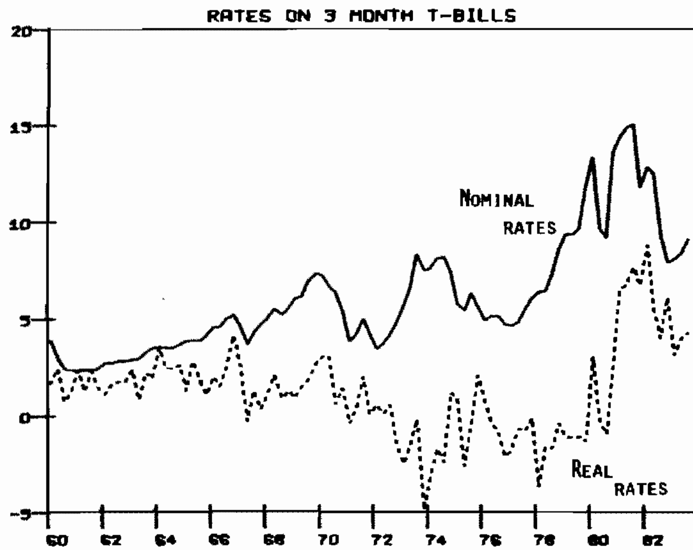
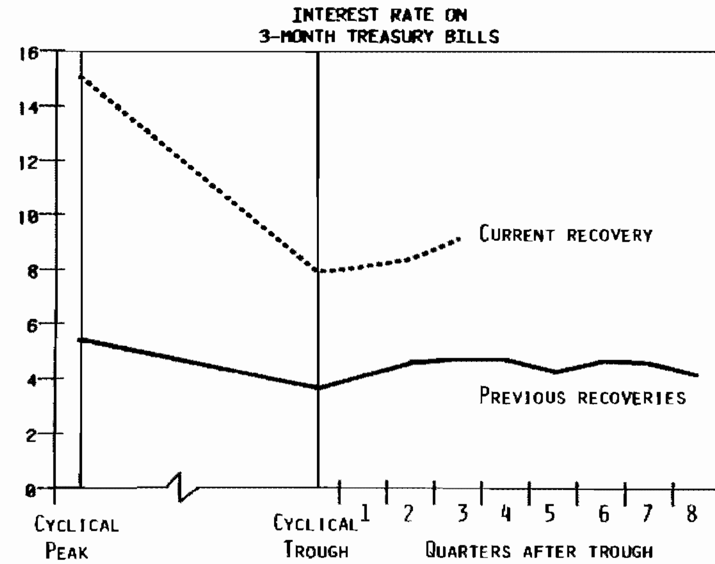
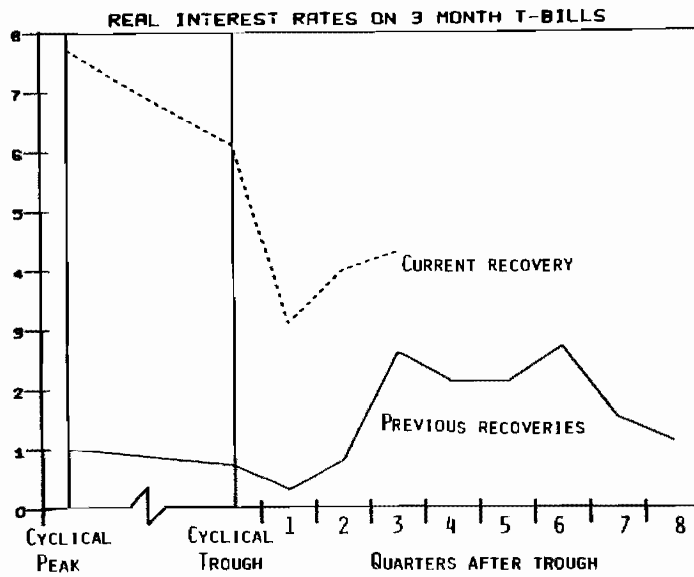


FIGURE 2. INTEREST RATES REMAIN HIGH.







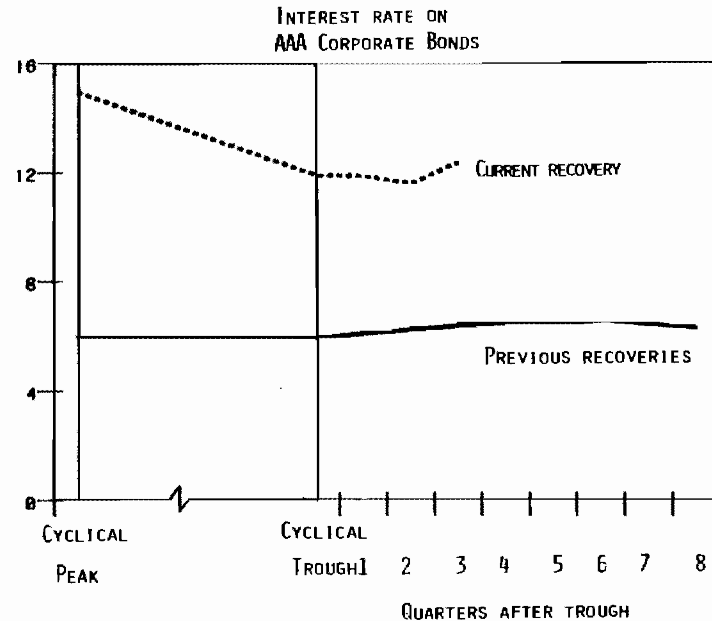
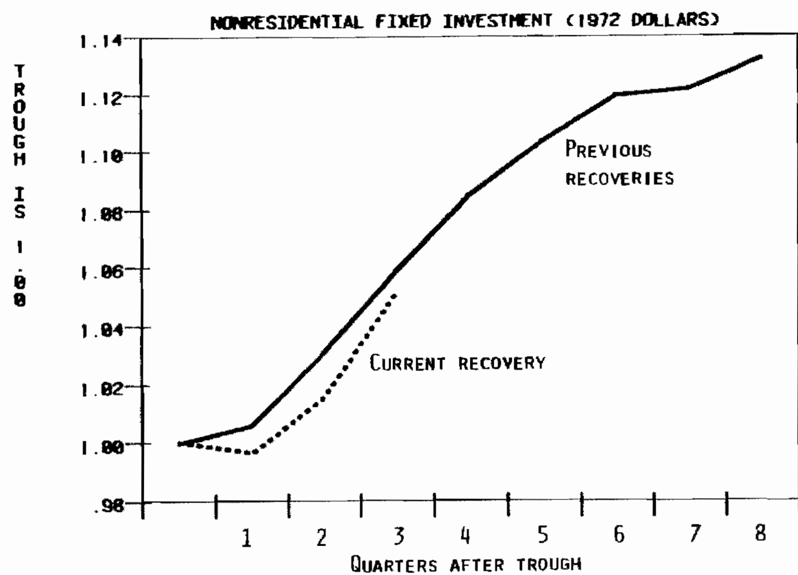
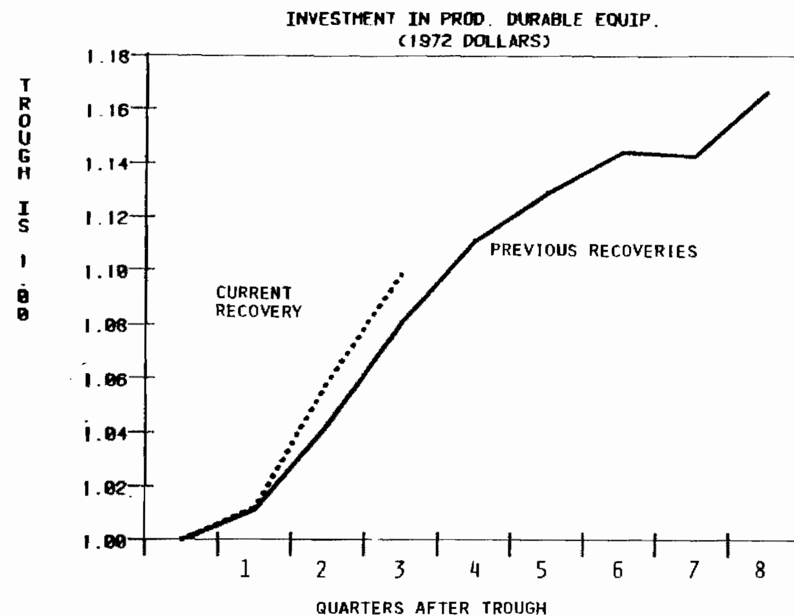
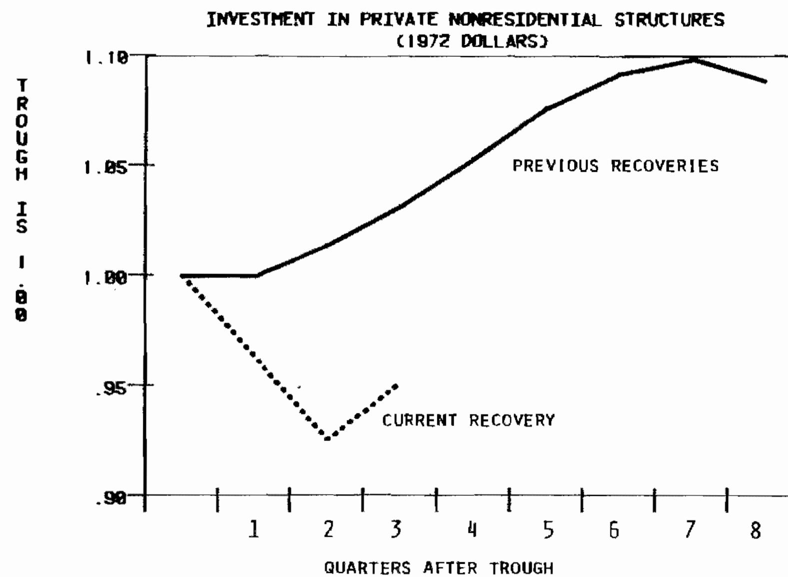


FIGURE 3. BUSINESS FIXED INVESTMENT HAS GROWN AS USUAL.

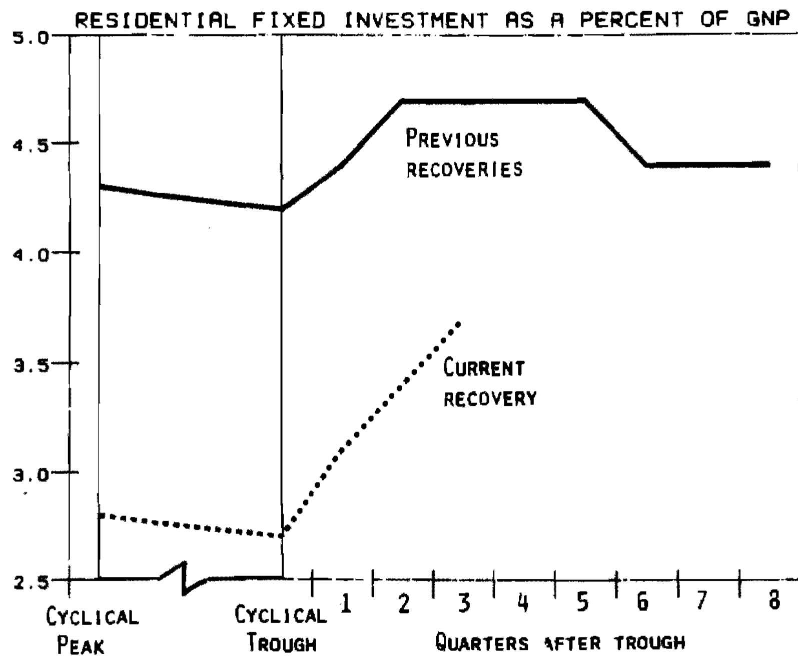






TOTAL BUSINESS FIXED INVESTMENT HAS GROWN AS USUAL

FIGURE 4. HOUSING INVESTMENT.



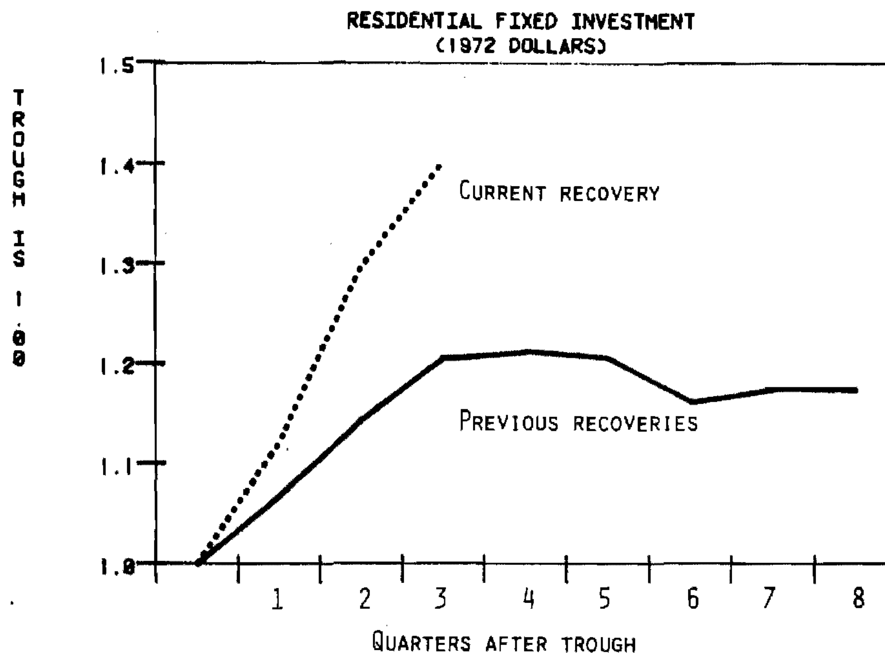


FIGURE 5. INVENTORIES AND NET EXPORTS ARE WEAK.