

STATEMENT OF

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before the

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Mr. Chairman, I am pleased to appear before this Committee as you begin work on the Second Concurrent Resolution for Fiscal Year 1982. My testimony today will present the updated economic forecast of the Congressional Budget Office (CBO) and the budget outlook.

CBO's updated economic forecast shows substantial improvement in the economy compared with the lackluster performance of recent years. The slowing of inflation that began in the first half of 1981 is projected to continue into 1982. Real growth is expected to pick up late in 1981 and to be strong in 1982. The major reasons for the projected improvement in economic growth are the moderation of inflation and the reduction in taxes contained in the Economic Recovery Tax Act of 1981.

This forecast of strong real growth and moderating inflation depends critically on two highly uncertain factors. First, the economic projections assume that there will be no upsurge in commodity prices, such as the shocks in food and fuel prices that contributed to the **economy's** poor performance in the last several years. Second, money growth, consistent with Federal Reserve targets, could prove to be incompatible with strong economic **growth.**

Even with the projected improvement in the economy, CBO anticipates a budget deficit of about \$65 billion in fiscal year 1982, declining gradually to about \$50 billion in fiscal year 1984. These projections assume the spending policies of the First Concurrent Resolution on the Budget for 1982, which include still-unspecified spending cuts in 1983 and 1984. The CBO projections thus indicate that sizable spending cuts or revenue increases beyond those contemplated in the first resolution would be needed to achieve the target of a balanced budget in 1984.

THE CBO ECONOMIC FORECAST

Economic activity has been sluggish recently and is expected to show little or no improvement until the end of 1981. Correspondingly, for the remainder of the year, the unemployment rate is likely to remain near the 7 to 7-1/2 percent range experienced since the beginning of the year. Although inflation, as measured by the Consumer Price Index (CPI), may worsen a bit for a while before it gets better, by **year's** end a reduced pace of inflation should be in evidence. Interest rates are also expected to begin moving downward later in the year in response to the improved inflation picture.

The CBO economic forecast for 1982 indicates that real growth will be strong, compared with that in 1981 and in the last several years. Inflation is expected to continue to decelerate.

From the fourth quarter of 1981 to the fourth quarter of 1982, real gross national product (**GNP**) is forecast to increase by about 4 percent, while inflation, as measured by the GNP implicit price deflator, is projected to moderate to a rate of about 7 percent. Interest rates, although lower than in 1981, should remain high in 1982 because of reduced money growth and strong credit demands. The unemployment rate is also expected to turn down in 1982 (see Table 1).

TABLE 1. THE CBO FORECAST

Economic Variable	Actual	Projected	
	1979:4 to 1980:4	1980:4 to 1981:4	1981:4 to 1982:4
Nominal GNP (percent change)	9.4	9.2 to 13.4	9.3 to 13.5
Real GNP (percent change)	-0.3	1.5 to 3.5	3.1 to 5.1
GNP Implicit Price Deflator (percent change)	9.8	7.6 to 9.6	6.0 to 8.0
Unemployment Rate (percent, fourth quarter)	7.5	7.1 to 8.1	6.6 to 7.6
3-Month Treasury Bill Rate (percent, calendar-year average)	11.6	13.5 to 15.5	11.4 to 13.4

The strong growth projected for 1982 is a consequence of the slowed pace of inflation and the tax cut. The moderation of

inflation is expected to reduce prices faster than wages thereby stimulating real income growth, which in turn will lead to stronger demands. The recently enacted cuts in individual and business taxes will also increase consumer purchasing power and stimulate business investment in 1982. At the same time, with less inflation, the assumed monetary policy will accommodate more real growth.

In the years beyond 1982, CBO assumes that inflation will continue to decelerate; real growth will remain relatively strong; interest rates will continue their downward trek; and the unemployment rate will decline somewhat. **In brief**, the CBO economic assumptions for the period 1982-1984 contrast sharply with the unfavorable economic developments of the past several years.

The basic outlook for economic **activity--slow** growth for the remainder of 1981 with improvement in **1982--has** not changed since **CBO's** forecast of last winter. The actual pattern of real growth for the first half of 1981 was close to that anticipated by CBO's winter forecast: The very strong performance in the early months of the year was followed by substantial weakening in the spring. The projected slowness of growth for the remainder of 1981 has not changed **significantly**, largely because interest rates have remained **high--even** somewhat higher than in the CBO winter forecast.

On the other hand, inflation has moderated more than projected earlier. This has improved the outlook for economic

activity as well as for inflation since CBO's winter **forecast**. The principal reasons for the improved inflation rate during the first half of 1981 were the very favorable price developments in the food and energy sectors and a higher value of the U.S. dollar on the **world's** currency exchanges. These favorable price "breaks" were not foreseen by forecasters six months ago. The **CBO** forecast of continued improvement in inflation is based on the assumption of no adverse movements either in world commodity prices or in the dollar exchange rate over the near term. Moreover, the reduced inflation momentum is expected to slow wage inflation and reduce interest rates, outcomes that make room for higher real growth and reduced unemployment rates.

Recognizing the critical importance of commodity prices in the CBO forecast highlights the elements of uncertainty involved in it. Food and energy prices, and the foreign exchange value of the dollar, have historically been volatile. Thus, if poor weather, unrest in the Middle East, or other uncontrollable factors should once again cause sharply increased food or energy prices, the economic outlook would be much less optimistic. On the other hand, a decline in energy prices would have a favorable impact on the **economy**.

Another area of uncertainty concerns the relationship between **economic** activity and money growth. Some analysts, apparently

including the Federal Reserve, argue that the Federal **Reserve's** targets for money growth are not consistent with strong economic growth, given the rates of inflation projected by most forecasters. The **CBO** forecast may be optimistic on this issue, **but--** given the projection of a decline in inflation and prospective changes in financial regulations and **institutions--not** overly optimistic.

THE BUDGET OUTLOOK

The major budgetary implications of the CBO economic forecast and longer-run economic assumptions relative to the first budget resolution targets are: lower **revenues**, largely as a result of somewhat lower projected economic growth and personal income levels; higher outlays, principally for interest on the public debt and other interest-rate sensitive programs; and, hence, greater **deficits**.

CBO's revenue **projections**, which are based on current tax law as revised by the Economic Recovery Tax Act, indicate that total revenues will rise from an estimated \$605 billion in 1981 to about \$655 billion in 1982, and to about \$750 billion in 1984 (see Table 2). This represents an average annual growth rate of about 7 **percent--less** than one-half of the average growth rate since 1976. **CBO's** revenue projections are very close to the first resolution target for 1982, but are lower by about \$15 billion for

TABLE 2. FEDERAL BUDGET ESTIMATES FOR FISCAL YEARS 1981-1984
(In billions of dollars)

Budget Aggregates	1981	1982	1983	1984
First Budget Resolution				
Revenues	603.3	657.8	713.2	774.8
Outlays	661.35	695.45	732.25	773.75
Surplus or deficit (-)	-58.05	-37.65	-19.05	1.05
Administration				
Revenues	605.6	662.4	705.8	759.0
Outlays	661.2	704.8	728.7	758.5
Surplus or deficit (-)	-55.6	-42.5	-22.9	0.5
CBO <u>a/</u>				
Revenues	605	653-658	693-703	740-755
Outlays	665	718-723	748-758	790-805
Deficit	60	60- 70	45- 65	35- 65

SOURCES: First Concurrent Resolution on the Budget for Fiscal Year 1982 (H. Con. Res. 115, approved May 21, 1981); Mid-Session Review of the 1982 Budget, July 15, 1981; Congressional Budget Office.

a/ Based on existing tax law as revised by the Economic Recovery Tax Act of 1981 and the spending policies specified by the first budget resolution.

1983 and by more than \$25 billion for 1984. The CBO revenue projections are also lower than the Administration's July estimates-- by about \$7 billion in 1982, \$8 billion in 1983, and \$11 billion in 1984. The differences between the various estimates are attributable largely to different economic assumptions (see Table 3)

TABLE 3. A COMPARISON OF ECONOMIC ASSUMPTIONS (By calendar year)

Economic Variable	1981	1982	1983	1984
GNP (billions of current dollars)				
First budget resolution	2,941	3,323	3,734	4,135
Administration	2,951	3,296	3,700	4,097
CBO <u>a/</u>	2,931	3,255	3,624	4,018
Real GNP (percent change, year over year)				
First budget resolution	2.0	4.1	5.0	4.5
Administration	2.6	3.4	5.0	4.5
CBO <u>a/</u>	2.3	3.1	4.1	4.0
GNP Implicit Price Deflator (percent change, year over year)				
First budget resolution	9.7	8.6	7.0	6.0
Administration	9.6	8.0	7.0	6.0
CBO <u>a/</u>	9.1	7.7	7.0	6.6
CPI (percent change, year over year) <u>b/</u>				
First budget resolution	11.1	8.3	6.2	5.5
Administration	9.9	7.0	5.7	5.2
CBO <u>a/</u>	10.1	7.2	7.0	6.2
Unemployment Rate (percent, annual average)				
First budget resolution	7.5	7.2	6.6	6.4
Administration	7.5	7.3	6.6	6.2
CBO	7.4	7.3	6.9	6.5
3-Month Treasury Bill Rate (percent, annual average)				
First budget resolution	13.5	10.5	9.4	8.2
Administration	13.6	10.5	7.5	6.8
CBO <u>a/</u>	14.5	12.4	11.4	10.1

SOURCES: Conference report on the First Concurrent Resolution on the **Budget--Fiscal** Year 1982 (to accompany H. Con. Res. 115, reported May 15, 1981); Mid-Session Review of the 1982 Budget, July 15, 1981; Congressional Budget Office.

a/ The economic projections for 1981 and 1982 are the midpoints of the economic forecast ranges. The projections for 1983 and 1984 are not forecasts; they are assumptions.

b/ The Consumer Price Index used by the Administration is for wage earners and clerical workers in urban areas; the index used for the first budget resolution and CBO assumptions covers all urban dwellers.

and to the fact that the timing and size of the actual tax cuts enacted in August were somewhat different than assumed for the first budget resolution.

On the spending side, total unified budget outlays are **pro-**jected by the CBO to rise from an estimated \$665 billion in 1981 to between \$718 billion and \$723 billion in 1982, and to between \$790 billion and \$805 billion in 1984. This would represent an average growth rate of about 6 percent annually, also less than one-half of the average growth rate since 1976. The CBO **projections--which** are based on the spending policies implicit in the first budget **resolution--exceed** the first resolution outlay targets by over \$20 billion in 1982, and by similar amounts in 1983 and 1984. They are also higher than the **Administration's** July **estimates--by** about \$15 billion in 1982, by over \$20 billion in 1983, and by over \$30 billion in 1984.

CBO's projected outlays are higher for two major reasons: higher estimates of interest on the public debt and other interest-related costs, and higher **estimates** of defense outlays. The higher interest costs result largely from **CBO's** assumption that interest rates will decline less rapidly during 1982-1984 than projected by the Administration or assumed for the first resolution targets. The higher CBO defense outlay **projections** represent technical estimating differences about how quickly budget

authority, especially for defense procurement programs, will spend out during the next several years. Other differences between the CBO outlay projections and the **Administration's** estimates result from somewhat different assumptions about the size of annual **cost-of-living** adjustments for Social Security benefits and other indexed programs, and from technical **reestimates** for farm price **supports**, food stamps, Medicare and **Medicaid**, and assistance **payments**.

CBO's budget projections indicate that the budget deficit for 1982 would be about \$65 billion, or over \$25 billion higher than specified by the first concurrent resolution, and more than \$20 billion higher than estimated by the Administration. Over the next two years, the CBO budget projections indicate that the deficit would fall gradually to about \$50 billion in 1984.

The CBO spending projections assume that substantial spending cuts will be **made--over** and above those contained in the Omnibus Budget Reconciliation Act of **1981--through** the appropriations process and by other legislative and administrative means. These further spending cuts amount to about \$15 billion in 1982, about \$35 billion in 1983, and about \$50 billion in 1984. These additional savings are implicit in the first budget resolution targets. The **Administration's** July budget estimates also assume further spending cuts of similar **magnitude**. A large portion of these

additional reductions have not yet been identified by the Administration. If the Congress does not approve these additional reductions, budget outlays and deficits could be substantially higher than projected by CBO. Similarly, under an alternative set of less favorable economic assumptions, the federal budget deficit in 1984 could exceed \$50 billion by a considerable margin.

THE BUDGET PROBLEM

Although the enactment of the Budget Reconciliation Act represents a major step toward achieving the spending reductions proposed by the Administration last March and embodied in the first resolution targets, the Congress still has ahead of it the **very** difficult and painful task of identifying further cuts. Moreover, the CBO budget projections indicate that these additional spending reductions may have to be even larger than now being contemplated if a balanced budget is to be reached by 1984.

I would like to conclude my statement this morning with some illustrations of why it will be very difficult and painful to reduce spending sufficiently to balance the budget by 1984.

The enactment of the Economic Recovery Tax Act puts in place the goal of both the Administration and the Congress to reduce the growth in federal revenues and the federal tax burden. During the next three years, revenues are projected to grow by a smaller rate

than the economy as a whole. Consequently, revenues as a percentage of GNP are projected to decline from 21 percent in 1981 to 19 percent in 1984.

The sharp curtailment of revenue growth over the next several years will require even greater reductions in federal spending relative to GNP in order to achieve a balanced budget by 1984. Federal outlays as a percentage of GNP now stand at 23 **percent**, so that spending will have to be reduced relative to GNP by four percentage points in the next three years to reach a balanced budget by 1984. There has not been such a sharp reduction in federal spending since the end of the Korean War, when federal outlays fell from 21 percent of GNP in **1953** to 17 percent in 1956. All of the reduction at that time was in national defense spending, which fell as a percentage of GNP from 13.8 percent to 9.6 percent.

The situation now is markedly different. The Administration and the Congress are committed to substantial real growth in defense spending. Under the CBO budget projections, defense outlays would increase relative to **GNP--from** 5.6 percent in 1981 to 6.7 percent in 1984. **Thus**, nondefense programs are the principal targets for major spending reductions. Spending for nondefense

programs, relative to GNP, would have to be reduced from over 17 percent in 1981 to less than 13 percent by ~~1984--a~~ level that last existed in 1970.

Some of this reduction of spending relative to GNP will occur without any additional spending cuts by the Congress. For example, as interest rates moderate, the relative size of interest costs will fall **automatically**. **Also**, as the unemployment rate declines, spending for unemployment benefits will fall relative to GNP. With the spending cuts already made by the Reconciliation Act, and the assumed decline in interest and unemployment rates, spending by 1984 for nondefense programs would be reduced to about 15 percent of GNP, under CBO's projections. But this leaves a considerable way to go to reach a target of under 13 percent of GNP for non-defense outlays by 1984, the level that would be necessary to achieve a balanced budget and allow for the projected growth in defense spending.

About **three-fourths** of nondefense spending today consists of benefit payments for individuals (such as Social Security, Medicare, federal employee retirement, unemployment compensation, and public assistance) and net interest costs. Most of this spending is mandatory under existing law. CBO projects that outlays for these two categories will grow from about \$385 billion in 1981 to about \$480 billion in 1984, or about 12 percent of GNP. With defense outlays in 1984 projected at about \$260 billion, and total revenues

at about \$750 billion, this would leave almost no room for any other federal spending if there is to be a balanced budget (see Table 4).

TABLE 4. FEDERAL BUDGET OUTLAY ESTIMATES FOR MAJOR PROGRAM CATEGORIES--THE ADMINISTRATION'S JULY ESTIMATES ADJUSTED FOR CBO ECONOMIC ASSUMPTIONS AND ESTIMATING METHODS (By fiscal year)

Major Category	Billions of Dollars		As a Percent of GNP	
	1981	1984	1981	1984
National Defense	161	261	5.6	6.7
Benefit Payments for Individuals	316	393	11.1	10.0
Net Interest	68	86	2.4	2.2
Other Federal Operations and Grants to State and Local Governments	120	102	4.2	2.6
Unspecified Savings to Be Proposed by the Administration	—	-44	—	-1.1
Additional Spending Cuts (or Revenue Increases) to Offset CBO Projected Deficit	—	-50	—	-1.3
Total	665	748	23.3	19.1

Alternatively, the projected growth in defense spending would have to be scaled back, benefit payment programs would have to be cut more than proposed to date by the Administration or assumed for the first budget resolution, and/or additional revenues would have to be generated. Otherwise, the goal of achieving a balanced federal budget will have to be postponed.

Moreover, to achieve substantial spending reductions in 1984, most of the actions will have to be taken on the 1982 and 1983 budgets. A large portion of the 1984 defense budget, especially for procurement programs, will be determined by 1982 and previous years' appropriations. With respect to benefit payments and grants to state and local governments, time must be allowed for the Congress to enact legislation and for the recipients to adjust to reduced funding levels. Thus, the budget problem facing the Committee is not only difficult and painful, its solution cannot be **delayed.**