

STATEMENT OF

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before the

Committee on the Budget

United States Senate

September 15, 1981

There should be no release
of this statement before its
delivery, scheduled for
10:30 A.M. (E.D.T.),
Tuesday, September 15, 1981

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 our estimate of 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 and an assumed pickup in the growth of money (M1B), which has recently been below the low end of the Federal **Reserve's** target range.

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. Although interest rates will remain high, they are projected to decline next year thereby inducing more real growth, particularly in residential construction. Growth in money aggregates at the upper end of the Federal **Reserve's** target ranges is expected to be consistent **with** a moderate easing of interest rates, because of the projected decline in inflation and innovations in financial markets that are expected to promote further economies in the use of money balances.

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. The principal reasons for the reduction in the **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," which were not foreseen by forecasters six months ago, have reduced inflation and improved the present outlook for real growth. CBO now projects about 4 percent growth during 1982, as compared with our winter forecast of nearly 3 percent. This revision in the forecast is almost exclusively the result of the improvement in the outlook for inflation. The CBO forecast of continued improvement in inflation is in turn 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 somewhat 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 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

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.

in 1984. The differences between the various estimates are attributable largely to different economic assumptions (see Table 3) 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**, CBO projects total unified budget outlays 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--again**, 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 nearly \$40 billion in 1984.

CBO's projected outlays are higher for two major reasons: first, higher estimates of interest on the public debt and other interest-related costs; and second, higher estimates of defense outlays. The higher interest costs result largely from **CBO's** assumption that interest rates will decline less rapidly between 1982 and 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

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.

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 additional 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. For 1982, the additional outlay reductions implicit in the first budget resolution targets amount to about \$15 **billion**. They consist of such items as further savings in Social Security benefits, reduced appropriation levels for discretionary programs, and administrative savings from accelerated collection of outstanding debts owed to the federal government and other **efficiencies**. These further reductions in 1982 would also reduce outlays in 1983 and 1984 by similar amounts. In addition, the first resolution targets

include unspecified reductions of \$20 billion for 1983 and \$28 billion for 1984 that were not **distributed** by functional categories. If these additional spending reductions do not materialize, budget outlays and deficits could be substantially higher than projected by CBO.

Similarly, if the economy is weaker than **projected--as** a result of higher interest rates or less rapid productivity growth, for **example--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 so 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. Thus, to reach a balanced budget by 1984, spending will have to be reduced relative to GNP by four percentage points in the next three years. Such a sharp reduction in federal spending has not occurred 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. Nondefense programs are the principal targets for major spending reductions. Spending for nondefense **programs**, relative to GNP, would have to be cut by more than four percentage **points--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 with the assumed decline in interest and unemployment rates, 1984 spending for nondefense programs would be reduced to about 15 percent of GNP, under **CBO's** projections.

But this still leaves a considerable way to go to reach a target of under 13 percent of GNP for nondefense outlays by **1984--** the level that would be necessary to achieve a balanced budget and allow for the projected growth in defense spending. The question is: Where can these savings be found?

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. With defense outlays in 1984 projected at about \$260 billion, and total revenues at about \$750 billion, this would leave very little 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)

| | 1981 | 1982 | 1983 | 1984 |
|--|------------------------|-------------|-------------|-------------|
| | In Billions of Dollars | | | |
| National Defense | 161 | 193 | 226 | 261 |
| Benefit Payments for Individuals | 316 | 341 | 367 | 393 |
| Net Interest | 68 | 81 | 87 | 86 |
| Other Federal Operations and Grants to State and Local Governments | 120 | 105 | 103 | 102 |
| Unspecified Savings to be Proposed by the Administration | -- | -- | -30 | -44 |
| Additional Spending Cuts (or Revenue Increases) to Reach Administration Deficit Targets for 1982 to 1984 | <u>---</u> | <u>-22</u> | <u>-32</u> | <u>-50</u> |
| Total | 665 | 698 | 721 | 748 |
| | As a Percent of GNP | | | |
| National Defense | 5.6 | 6.1 | 6.4 | 6.7 |
| Benefit Payments for Individuals | 11.1 | 10.7 | 10.4 | 10.0 |
| Net Interest | 2.4 | 2.6 | 2.5 | 2.2 |
| Other Federal Operations and Grants to State and Local Governments | 4.2 | 3.3 | 2.9 | 2.6 |
| Unspecified Savings to be Proposed by the Administration | -- | — | -0.8 | -1.1 |
| Additional Spending Cuts (or Revenue Increases) to Reach Administration Deficit Targets for 1982 to 1984 | <u>—</u> | <u>-0.7</u> | <u>-0.9</u> | <u>-1.3</u> |
| Total | 23.3 | 22.0 | 20.4 | 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.