STATEMENT OF

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There should be no release of this document before its delivery, scheduled for 10 a.m. (EST), March 5, **1980.**

Mr. Chairman, I am pleased to appear before this Committee as you prepare to mark up the first concurrent budget resolution for fiscal year 1981 and revise the second resolution for this year.

Your deliberations occur at a critical time for the economy. During the past year, inflation accelerated to more than 13 percent--an extraordinarily high level--while economic activity slowed sharply. Real GNP rose just 1 percent in 1979--well below the 4.8 percent rate recorded in 1978. Interest rates jumped to record high levels; the growth in employment slowed; and real disposable personal income fell.

Most forecasters see no improvement this year. In January, inflation accelerated further and the unemployment rate rose to 6.2 percent. The consensus projection shows high inflation, weak economic activity, and a continued rise in the jobless rate in the year ahead.

Most forecasters also agree on another point: The economic outlook is particularly uncertain, for at least three reasons. First, there is a great deal about the recent behavior of the economy that is not well understood--especially the drop in both the personal saving rate and labor productivity. Second, with interest rates and inflation at record levels, past experience provides little guidance for economic forecasters. And third, recent international developments have raised widespread speculation about increases in defense spending, while the acceleration of inflation has raised prospects for cuts in nondefense spending.

THE ECONOMIC OUTLOOK

The latest CBO economic forecast, revised to take account of economic events since January, is summarized in Table 1. As the table shows:

- Real gross national product (GNP) is expected to range from about zero growth to a 2 percent decline from the fourth quarter of 1979 to the fourth quarter of 1980. During 1981, growth in real GNP is expected to recover moderately, rising between 1.3 and 3.3 percent.

- The surge in consumer prices is projected to moderate slightly to the range of 10.6 to 12.6 percent from the fourth quarter of 1979 to the fourth quarter of 1980, and to remain at a high rate in 1981.

- The unemployment rate is forecast to average between 6.3 and 7.3 percent in 1980, rising to 7.0 to 8.0 percent in 1981.

The CBO forecast is based on two assumptions about economic policy:

- First, federal spending and tax policies for fiscal years 1980 and 1981 is assumed to be those specified in current law. The previously legislated increases in Social Security taxes scheduled for 1981 are assumed to take place.

- Second, the Federal Reserve is assumed to hold money growth near the midpoint of the announced target range.

Compared with CBO's January forecast (displayed in the lower panel of Table 1), the revised forecast shows higher inflation, especially as measured by the Consumer Price Index (CPI); the upward revision is attributable partly to higher interest rates both in the current quarter and for the forecast period. The projected decline in real activity has not been changed significantly. Unemployment rates are somewhat lower than in the earlier forecast.

TABLE 1. CBO'S ECONOMIC PROJECTIONS BASED ON CURRENT LAW

Economic Variable	1978:4 to 1979:4 (actual)	1979:4 to 1980:4	1980:4 to 1981:4
		The Revised Forecast	
Nominal GNP (percent change)	10.0	6.8 to 10.8	10.0 to 14.2
Real GNP (1972 dollars, percent change)	1.0	-2.0 to 0.0	1.3 to 3.3
Consumer Price Index (percent change)	12.7	10.6 to 12.6	8.9 to 10.9
Unemployment Rate, Average for the Year (percent)	5.8	6.3 to 7.3	7.0 to 8.0
		The January 1980 Forecast	
Nominal GNP (percent change)	10.0	5.7 to 9.8	10.2 to 14.4
Real GNP (1972 dollars, percent change)	1.0	-2.3 to -0.3	2.0 to 4.0
Consumer Price Index (percent change)	12.7	8.6 to 10.6	8.3 to 10.3
Unemployment Rate, Average for the Year (percent)	5.8	6.5 to 7.5	7.5 to 8.5

CBO's revised current law forecast still shows a mild recession in 1980 and a weak recovery in 1981. The fundamental causes of the projected downturn in real activity are increased OPEC oil prices, generally high inflation, record high interest rates, and depleted personal savings.

Rapid inflation and tight credit conditions depressed real income growth and household spending in 1979 and continue to do so this year. The adverse impact of the tightening of credit conditions by the Federal Reserve since last October can be seen in the recent drop in housing starts and home sales. Meanwhile, rising gasoline prices and lagging real incomes have sharply weakened sales of domestic automobiles. As a result, about one-quarter of the industry's blue-collar workers are on indefinite layoff and a significant recovery in auto output is not expected until next summer or later.

The accumulating problems in the housing and automobile sectors are particularly important for the overall outlook because together they account for a significant portion of total domestic production. When the likely secondary effects on suppliers of these industries and on producers of related products are included, the overall impact on the economy is substantial. Retail sales other than autos are also projected to slow down in 1980 because of lagging real income growth, heavy debt burdens, and the already low rate of personal saving.

Nevertheless, CBO still does not expect a deep recession in 1980. The projected slowdown in household spending is offset in part by the forecast behavior of other sectors. First, most indicators of future business spending suggest that this sector will be stronger in 1980 than in most past recessions. Second, net exports are expected to be a source of growth during this year. A domestic economy in a recession will demand fewer imports, while somewhat stronger foreign economic growth likely will bolster the demand for U.S. exports. Finally, and most important, the available data indicate that inventories have remained roughly in line with sales. Consequently, a severe curtailment of production to trim unwanted stocks seems unlikely.

For 1981, CBO continues to expect a less robust recovery than the typical postwar upswing. The major reasons, aside from the shallowness of the recession, are threefold. First, high inflation will continue to constrain the purchasing power of rising money incomes. Second, high inflation and the international condition of the dollar are expected to persist in keeping short-term interest rates high. Third, a sizable braking effect on the economy will come both from the Social Security tax increases scheduled for 1981 and from the combination of inflation and the progressive income tax structure, which pushes taxpayers into higher tax brackets.

The sharp rise in prices in the forecast period reflects continued passthrough of fuel costs and very high interest and labor costs. Attempts by workers to restore real incomes are expected to boost labor costs. CBO projects especially large increases in the CPI, to which many spending programs are indexed. Many economists believe that this measure has exaggerated changes in the cost of living in the past few years because of its treatment of housing costs. The CPI has increased more rapidly than other measures of inflation partly because of rising mortgage interest rates. Although tight credit conditions eventually reduce demands and slow the accompanying inflation, higher interest rates initially cause mortgage rates, and consequently the CPI, to rise, which in turn may trigger increased spending and larger wage adjustments.

In summary, inflation is now even more serious than just a few months ago, while the economy still appears to be precariously balanced between recession and a path of little growth. The outcome is uncertain, but most forecasters, including CBO, expect a combination of high inflation and recession in the year ahead.

THE BUDGET OUTLOOK

Fiscal Year 1980. The second concurrent resolution for fiscal year 1980 approved by the Congress last November specified revenues of $517.8 billion, outlays of $547.6 billion, and a deficit of $29.8 billion.

On the basis of our March economic forecast, actual spending through January, and the Administration's latest budget estimates released in January, it is apparent that 1980 outlays will be significantly higher than assumed for the second resolution. CBO's estimate of outlays resulting from actions already completed by the Congress plus certain mandatory supplementals is almost $560 billion, more than $12 billion above the second resolution ceiling.

The increased estimates of outlays can be attributed to various items; for example, an additional $7 billion for higher interest costs, $2 to $3 billion for higher farm price supports resulting largely from the recent grain embargo, $2 billion for lower asset sales of federally held mortgages and loans, and $2.5 billion for faster spending rates for defense procurement and several federal grant programs.

The Administration's January budget estimate for 1980 outlays is $563.6 billion, or $16 billion above the second resolution. The Administration's higher outlay estimate for 1980 includes proposed supplementals for items such as food stamps, defense and energy programs.

Revenues for 1980 are now estimated to be about $521 billion, including the windfall profits tax. This is over $3 billion above the second resolution level. The increase is primarily due to the higher forecast for inflation. The budget deficit for 1980 is likely to be as much as $10 billion or more above the second resolution level, largely because of the expected higher spending.

Fiscal Year 1981. Turning to fiscal year 1981, the President's budget proposes revenues of $600 billion, outlays of $615.8 billion, and a budget deficit of $15.8 billion. The proposed budget places primary emphasis on restraining inflation and moving toward budgetary balance. The 1981 budget deficit would be $24 billion lower than the $40 billion deficit estimated for 1980 by the Administration in the January budget. This reduction would be achieved by permitting little real growth in total spending and allowing tax burdens to rise to the highest levels since World War II.

The major revenue initiatives proposed in the President's budget include the windfall profits tax on oil production and cash management proposals that would accelerate certain tax collections. The absence of a tax cut in 1981, coupled with $21 billion in estimated additional revenues from the windfall profits tax and other revenue initiatives, would increase the ratio of federal revenues to GNP to almost 22 percent.

The major spending initiative in the President's budget is increased budget authority for defense programs of about 5 percent in real terms--with continued real growth in 1982 and 1983. The focus of debate on the appropriate amount of real growth in defense spending has shifted this year from outlays to budget authority. Higher spending for payments for individuals, many of which are adjusted automatically for increases in the cost of living, and for national defense account for nearly all of the projected $52 billion growth in outlays in the Administration's budget.

Increased spending in other federal programs would be offset primarily by reduced outlays for farm price supports, unusually high levels of sales of federal assets, and various legislative savings proposals--that is, proposed changes to existing law to achieve reductions in otherwise mandated spending. These legislative savings proposals, which total over $5 billion for 1981, have been proposed in previous budgets but have not yet been approved by the Congress.

CBO Reestimates of the 1981 Budget. CBO has reestimated the Administration's budget proposals using our own economic assumptions and estimating methodology. On this basis, CBO estimates that revenues would total a little over $609 billion, outlays would total $629 billion, and the budget deficit would be about $20 billion. The major CBO reestimates of the Administration's budget are shown in Table 2.

On the revenue side, CBO estimates that current law revenues would be almost $10 billion higher than the Administration estimate, largely because of a higher forecast of inflation. On the other hand, the budget estimate for the windfall profits tax appears to be slightly overstated based on the tax conference agreement.

For outlays, the impact of the revised CBO forecast would be to increase outlays by about $6 billion for interest on the public debt and indexed benefit payment programs such as Social Security. CBO also estimates that defense spending in 1981 would be over $2 billion above the level estimated by the Administration, based on recent spending patterns. Faster spending rates for such grant programs as community development grants, federal-aid highways, and EPA construction grants add another $2 billion to 1981 outlays.

CBO's estimate of the cost savings that would result from the passage of hospital cost containment legislation is about one-half of the Administration's $780 million estimate, largely because of different assumptions concerning the response of hospitals to the incentives and controls that would be established. CBO also estimates that Medicare and Medicaid outlays in 1981 could be another $900 million higher than those included in the President's budget because of higher utilization rates, lower savings from administrative cost reduction items, and other differences in programmatic assumptions. Finally, CBO estimates that receipts derived from the sale of leases of Outer Continental Shelf lands and royalties from mineral production could be $800 million less than projected by the Administration.

TABLE 2. CBO ESTIMATES OF THE ADMINISTRATION'S FISCAL YEAR 1981 BUDGET PROPOSALS: IN BILLIONS OF DOLLARS

Revenues	
Administration's estimate	600.0
CBO reestimates	
Current law revenues	9.6
Windfall profit tax	-0.4
CBO estimate of Administration's revenue proposals	609.2
Outlays	
Administration's estimate	615.8
CBO reestimates	
Net interest	4.5
Social Security and other indexed benefits	2.2
Defense spending	2.5
Federal grants for community development, highways, urban mass transportation, and municipal waste treatment facilities	1.7
Medicare and Medicaid	1.3
OCS rents and royalties	0.8
All other, net	0.2
CBO estimate of Administration's outlay proposals	629.0

In addition, the Administration's January budget does not include the impact of increased fuel costs on defense operations, which could require as much as $2.5 billion in 1980 and $4.1 billion in 1981. Enactment of the Nunn-Warner selective pay raises for military personnel could add another $500 million in 1980 and $800 million in 1981 for defense spending. Since January, there has been an increase in the tempo of defense activities in the Indian Ocean, which will also add to defense costs. In addition, spending in 1981 could be higher if the Administration's legislative savings proposals are not approved by the Congress, and if the large asset sales planned by the Administration do not occur to the extent estimated.

CONCLUSION

In view of the recent acceleration of inflation and the projected rapid growth in federal spending, there is now a great deal of discussion concerning spending cuts. The recent CBO background paper, *Reducing the Federal Budget: Strategies and Examples*, prepared at the request of the Chairman and Members of the House Budget Committee, lists a large number of illustrative spending cuts, with estimates of the expected savings. For example, some of the larger cuts for fiscal year 1981 would be $1.6 billion for eliminating subsidies to the U.S. Postal Service and $2.4 billion for eliminating general revenue sharing for states. To achieve much greater savings from a single program would probably require a cut in defense or in one of the entitlement programs such as Social Security. Thus, to achieve a large saving may require difficult cuts in many programs. As you know, the Administration is now studying spending cuts for this year and fiscal year 1981.

A cut in federal spending can be expected to reduce aggregate demand temporarily and thereby help curtail inflation. With respect to their impact on the overall economy, however, such policies are not costless. They generally have an adverse effect on unemployment, at least for a few years. Moreover, one should not expect that restrictive budget policies will provide a "quick fix" of the inflation problem. Past experience suggests that such policies are not likely to have a large impact on inflation in the first year.

Although monetary and fiscal policy do have the potential for improving the economic performance of the economy through their effects on aggregate demand, they do not address directly the fundamental economic problem of the 1970s--fluctuations in prices and employment arising from changes in aggregate supply and reduced growth in productivity. These economic problems require a longer-run approach. Thus, traditional demand management policies may help to offset the real effects of a "supply shock," such as a sharp increase in the price of imported oil. But longer-run policies to encourage conservation or to increase domestic energy supplies are needed to get to the root of this problem.

The same is true of productivity growth. In order to achieve high growth rates, it may be necessary to tailor fiscal policies to promote research and development, to encourage saving rather than consumption, and to provide a sufficient return on capital investment to ensure a more rapid modernization of the nation's plant and equipment.

APPENDIX. COMPARISON OF FORECASTS

The revised CBO forecast is in general agreement with the consensus view among economic forecasters, which projects high inflation, weak productivity gains, and rising unemployment during the next year or two.

A comparison of CBO's forecast for calendar year 1981 and those of other forecasters is not meaningful because forecasts for that year are greatly influenced by differing assumptions about tax cuts and federal spending levels.

TABLE 3. COMPARISON OF REVISED CBO AND OTHER FORECASTS FOR CALENDAR YEAR 1980

	Real GNP (percent change)	Unemployment Rate (percent)	Consumer Price Index (percent change)
Commercial Models			
Chase Econometrics a/	-0.9	7.1	13.4
Data Resources, Inc. b/	0.2	6.6	12.9
Merrill Lynch c/	-1.3	7.5	12.0
Wharton Associates d/	0.0	6.9	12.0
Average of 42 Business Forecasts e/	-0.3	7.0	11.6
Revised CBO (mid-point of projected range)	0.0	6.8	13.0

a/ February 23, 1980.
b/ February 22, 1980.
c/ February 4, 1980.
d/ January 28, 1980.
e/ From Blue Chip Economic Indicators, vol. 5, no. 2, February 10, 1980.