STATEMENT
by

Alice M. Rivlin, Director, Congressional Budget Office

Senate Budget Committee
September 23, 1975

Last week the Congressional Budget Office issued its second report on the economy, entitled Recovery: How Fast and How Far? In my testimony this morning I'd like to summarize our findings in that report, and then discuss the relation of those findings to the Federal budget and the targets of the First Concurrent Resolution on the budget.

The Economic Outlook

The U. S. economy is beginning to recover from its longest and worst recession since the 1930s, but it is not at all clear that the recovery will be sustained enough to carry the economy up the long road to full employment. As of mid-September, these points about the recovery warrant particular emphasis:

- The economic signs point to rapid growth in production in the fall and winter.
- Renewed inflation, spurred by food and fuel prices, is likely to accompany the recovery.

- o Rising food and fuel prices and tighter monetary policies may retard or even thwart the recovery after the initial rebound.
- o Even if production and employment continue to rise after the initial rebound, the recession has been so deep that unemployment will remain high for some years.

Production and Employment. Optimism about the months immediately ahead is based on recent advances in business sales and new orders, coupled with rapid progress in reducing the inventories that piled up during the recession. Inventory liquidation is not yet over, but has progressed far enough for future advances in sales and orders to be translated into higher levels of production and employment. The decline in the unemployment rate to 8.4 percent in July and August may in fact be an early response to the improved sales and order picture.

Whether the expected strong improvement in production and employment continues beyond the next few months is uncertain. The current increase in consumer spending may prove to be a temporary response to the tax cuts and benefit increases enacted in 1975. Sustained economic growth will require continuing strength in several areas of demand -- housing, domestic automobiles, other consumer goods, exports, capital goods, or government purchases.

<u>Prices and Interest Rates</u>. An especially worrisome aspect of the current economic situation is the danger of renewed inflation before the recovery gets a strong start. The rate of inflation, after slowing markedly early this year, began advancing again in June and July (as measured by the Consumer Price Index). The CPI increased only .2 percent in August, but it is hard to tell whether this represents a slowdown of inflation or is only a very short run phenomenon. The rate of increase of the CPI for June, July, and August taken together was 2.2 percent or 8.8 percent at an annual rate. The renewal of inflation is not a result of current pressures on capacity or labor shortages; excess capacity and unemployment remain high and wage increases have moderated from their high rates of mid-1974. Rather, the recent spurt in prices is due primarily to special food and fuel developments. Recent increases in interest rates have also contributed to rising costs.

Major uncertainties about future food prices center on the extent of Soviet grain purchases and the size of grain crops here and in Europe. Uncertainties about the energy price situation center around the future of oil price controls and the size of any additional oil price rise by OPEC nations. If food and fuel price increases continue they will not only hurt consumers directly, but may trigger a new round of wage, cost, and price increases and retard or even abort the recovery itself.

Economic Projections

The projections of inflation and unemployment through the end of 1977 shown in Table 1 are based on these assumptions:

- o a rise of 9 percent per year in food prices;
- o no decontrol of "old" oil, removal of the $2.00 tariff on imported oil and a moderate price increase ($1.50 a barrel) by OPEC this fall;
- o fiscal policy conforming to the first concurrent resolution on the budget; and
- o money supply growth at less rapid rates than those of this spring, with the rate of growth declining toward the targets of 5.0 to 7.5 percent per year announced by the chairman of the Federal Reserve Board.

Through early 1976, the Congressional Budget Office (CBO) projects a rapid rate of recovery from the bottom of the recession. Beginning in mid-1976, however, tighter monetary policies and the impact of higher prices are expected to retard the recovery. By the end of 1976, the projections indicate an unemployment rate in the 6.9 to 7.6 range--representing some 7 million unemployed persons--and an inflation rate of 6.0 to 7.5 percent. During 1977 the projections suggest slightly less inflation and little or no improvement for unemployment.

Compared to the budget committee's estimates at the time of the first concurrent resolution, the current CBO projections are similar on unemployment and somewhat higher on inflation. Compared to its last projections on June 30,

TABLE I--PROJECTIONS OF INFLATION AND
UNEMPLOYMENT, 1975-77

	General Price Index (GNP deflator)		Unemployment Rate (percent)
	Index 1958 = 100	Percent Change from a Year Ago	
1975:II (actual)	184	+9.9	8.9
1975:IV	189 - 191	6.0 - 8.0*	8.1 - 8.6
1976:IV	200 - 205	+6.0 - 7.5	6.9 - 7.6
1977:IV	210 - 220	+5.5 - 7.0	6.6 - 7.5

*Percent change for 1975:IV is change from 1975:II at an annual rate.

1975, CBO has become slightly more optimistic on inflation, due to changes in the assumptions about oil prices, and also more optimistic on unemployment, due partly to the oil assumptions and partly to recent economic news.

Projections beyond 1977 are subject to considerable uncertainty. Many unanticipated events could occur that could affect the economy. Food and energy price developments beyond 1977 are difficult, if not impossible, to foresee. Political factors could also affect the course of economic policy. Cyclical changes are also difficult to predict several years in advance.

The projections shown in Table 2 assume that the economy maintains a slow but steady growth after 1977. If this happens unemployment could fall to slightly below 6 percent by 1980. This projection assumes moderation of food and energy price increases, bringing the inflation rate down to the 5 percent range by the end of the decade. Further, monetary and fiscal policy is assumed to be conducive to slow sustained growth. This would necessitate some tax reductions during the period to offset accelerating revenues caused by inflation coupled with real growth in government purchases at about the same rate that the economy is growing.

Such a pattern of slow but steady growth would mean lower inflation and unemployment by 1980; but both are projected to remain above their postwar historical averages.

TABLE 2

PROJECTIONS OF GNP, PRICES, AND UNEMPLOYMENT IN 1980

	1977:4	1980
GNP	1875 - 1935	2490 - 2540
GNP (1958 dollars)	880 - 900	1020 - 1035
Consumer Price Index	186 - 195	220 - 230
Unemployment Rate	6.6 - 7.5	5.5 - 6.3

The Federal Budget and the Economic Outlook

One of the key assumptions underlying the economic projections just presented is adherence to the spending and revenue targets of the First Concurrent Resolution. At present it is impossible to know exactly how realistic that assumption will turn out to be. Both Congressional actions and economic developments can still influence the actual outlays and revenues for FY 76. Nevertheless, at present there is no clear reason to expect that the deficit will be substantially larger than the $68.8 billion projected for FY 76 in the first Concurrent Resolution.

The first Concurrent Resolution set an outlay target of $367.0 billion for FY 76. As may be seen in Table 3, actions completed or underway in the Senate to date would produce estimated outlays of $287.4 billion for that year. However, $84 billion of presidential requests remain to be reported in the Senate. If all the presidential requests were approved and signed, outlays would be $371.4 billion or $4.4 billion in excess of the Concurrent Resolution target.

The actual excess could, of course, be either smaller or larger than $4.4 billion. One Senate action last week which reduced the excess (and is already reflected in Table 3) is

TABLE 3

STATUS OF FEDERAL OUTLAYS FOR FISCAL 1976
(billions of dollars)

Functional Category	First Concurrent Resolution Target	Completed Action and Senate Action Under Way	President's Spending Requests not yet Reported in Senate	Remainder: Amount Remaining if Action Under Way and President's Requests are Approved Without Change	
				Under Target	Over Target
TOTAL	367.0	287.4	84.0		4.4
National Defense	90.7	23.8	70.6		3.8
International Affairs	4.9	3.4	1.6		0.1
General Science, Space and Technology	4.6	4.1	0.4	*	
Natural Resources, Environment and Energy	11.6	6.4	4.4	0.9	
Agriculture	1.8	2.3	-		0.5
Commerce and Transportation	17.5	16.7	*	0.8	
Community and Regional Development	8.65	6.1	0.5	2.1	
Education, Manpower and Social Services	19.85	18.6	0.6	0.7	
Health	30.7	32.1	0.7		2.1
Income Security	125.3	122.4	3.3		0.4

*Less than $50 million

(continued)

TABLE 3: (Continued)

STATUS OF FEDERAL OUTLAYS FOR FISCAL 1976

(billions of dollars)

Functional Category	First Concurrent Resolution Target	Completed Action and Senate Action Under Way	President's Spending Requests not yet Reported in Senate	Remainder: Amount Remaining if Action Under Way and President's Requests are Approved Without Change	
				Under Target	Over Target
Veterans Benefits and Services	17.5	18.1	0.3		0.9
Law Enforcement and Justice	3.4	3.3	*	0.1	
General Government	3.3	2.7	0.5	0.1	
Revenue Sharing and General Purpose Fiscal Assistance	7.2	7.0	0.3		0.1
Interest	35.0	36.2	-		1.2
Allowances	1.2	0.3	0.9	*	
Undistributed Offsetting Receipts	(16.2)	(16.2)	-	-	-

Note: Columns may not total due to rounding.

Source: Senate Budget Scorekeeping Report, No. 7, September 22, 1975.

the approval of "caps" on pay increases for federal workers. The excess could also be reduced if the Senate fails to approve all presidential requests. The defense area where presidential requests are substantially in excess of the targets in the first Concurrent Resolution.

Increases in the excess above $4.4 billion could be caused by new legislation, including spending in the middle east and anti-recession programs. Increases could also be caused by upward revisions of "uncontrollable" spending. The figures in Table 3 already reflect nearly $4 billion of such upward revisions concentrated in the areas of interest payments, health and income security programs, and veterans benefits. It now appears that more upward revisions are likely, principally in unemployment compensation, veterans' benefits, and medicare and medicaid. The amount of these additional upward revisions seems likely to fall in the $2.3 to $3.3 billion range.

On the revenue side, some increases above first Concurrent Resolution targets also appear likely. The main factor contributing to the upward revision is personal income tax receipts. Personal income has been growing more rapidly than was anticipated in May, and capital gains have been running higher than the Treasury had expected. Revisions from these sources are estimated to raise revenues $8.3 billion above the targets of the first Concurrent Resolution.

Part of the increase in expected revenues, however, is likely to be offset by removal of import fees on imported oil. CBO estimates that if both the $2 per barrel import fee on crude petroleum and 60¢ per barrel on petroleum products were removed effective October 1, 1975 (and fees already collected not rebated), the revenue lost would be $2.7 billion. The combined effect of the upward revision in personal tax collection and removal of the import fee would be FY 76 revenues of $303.8 billion, a figure of $5.6 billion higher than the first Concurrent Resolution target.

It should also be noted that the revenue estimate of $303.8 billion for FY 76 includes two important legislative changes assumed in the resolution but not enacted to date; namely extension of the 1975 tax cuts (which would lose $4.4 billion in revenues) and tax reform sufficient to capture $1 billion in revenues.

Thus both outlays and revenues are likely to exceed the targets of the first Concurrent Resolution. At the present time the excess for outlays appears likely to be slightly larger than the excess for revenues, which implies a deficit slightly above the target of $68.8 billion. There are, however, a great many uncertainties underlying this judgment and no grounds to date for predicting a deficit substantially above the first Concurrent Resolution target.

Alternative Policies, the Budget, and the Economy

Alternative economic policies would lead to different economic projections and different Federal deficits. Of the many possible combinations, CBO has analyzed an expansionary strategy of fiscal and monetary policies designed to speed the recovery and a contractionary strategy designed to limit federal deficits and reduce the rate of inflation. These two strategies do not correspond to specific legislative proposals; indeed, the monetary component of the strategies is not under the immediate control of the Congress at all. The strategies are intended to suggest what kinds of difference to the economy different policies can make. CBO can apply the same methods used to estimate the effects of these strategies to actual legislative proposals.

The expansionary option consists of a federal spending increase of $10 billion and a tax cut of $15 billion (in addition to extension of the temporary tax cuts enacted in 1975) both effective at the beginning of 1976, plus enough monetary growth to prevent short-term interest rates from rising higher than in the basic projections. CBO's analysis suggests that this strategy would increase the Federal deficit, but by much less than the $10 billion spending plus the $15 billion tax cut. The stimulus to the economy provided by these policies would gradually generate more tax receipts and lower income support payments, so that the net effect on the deficit by the end of 1977 would be $10 billion rather than $25 billion.

The effects on the economy of this strategy are shown in Table 4. According to CBO's estimates it would reduce the projected unemployment rate by about 0.7 of a percentage point below what it would otherwise be by late 1976 and by 1.1 percentage points, or about 1 million workers a year later. All three components of the package contribute to this reduction.

The cost of this strong recovery option in terms of additional inflation shows up gradually over a period of years. CBO has made estimates of the effect five years later, showing an inflation rate some 0.5 to 0.7 percentage points higher than it otherwise would be; that is, 5.5 or 5.7 percent if the rate would otherwise be 5 percent.

The contractionary strategy consists of allowing the temporary provisions of the Tax Reduction Act of 1975 to expire, federal spending $10 billion below the level specified in the first concurrent resolution, and a monetary growth rate low enough to keep short-term interest rates at the same levels as in the basic projections. This strategy would reduce the deficit, but again by less than the $10 billion spending reduction plus the approximately $9 billion tax change. The net reduction in the deficit is estimated at $10 billion by the end of 1977.

TABLE 4--POLICY ALTERNATIVES: FISCAL AND MONETARY POLICIES

Expansionary Strategy

EFFECT OF POLICY ON:	Spending Component	Tax Component	Monetary Component	Three Components
Unemployment Rate (percentage points):				
1976:IV	-.4	-.3	-.1	-.7
1977:IV	-.4	-.4	-.3	-1.1
Annual Rate of Inflation (percent change, General Price Index):				
1976	0	-.1	0	0
1977	.2	.1	.1	.4
1980	.2	.2	.2	.5 to .7

Contractionary Strategy

EFFECT OF POLICY ON:	Spending Component	Tax Component	Monetary Component	Three Components
Unemployment Rate (percentage points):				
1976:IV	+.3	+.2	+.1	+.6
1977:IV	+.4	+.3	+.2	+.9
Annual Rate of Inflation (percent change, General Price Index):				
1976	0	0	0	0
1977	-.1	-.1	0	-.2
1980	-.2	-.1	-.1	-.3 to -.4

The effects of the economy of these policies, according to CBO's analysis, would be an unemployment rate of 0.6 percentage points higher than in the standard projection by the end of 1976 and 0.9 percentage points higher a year later. The gain in terms of reduced inflation would be an inflation rate 0.3 to 0.4 percent lower than it would otherwise be five years from now.

The Effect of Decontrol of Oil Prices

Energy policy could also cause significant changes in the economic outlook. There are many uncertainties about the prices of oil and other energy sources in the months ahead, depending on the actions of the OPEC cartel as well as Presidential and Congessional actions. One policy which would both contribute to the inflation and retard the recovery is immediate decontrol of oil prices. CBO estimates that by the end of 1976, decontrol would add 1.5 percent of the rate of inflation (the GNP deflator) and 0.5 percentage points to the unemployment rate. By the end of 1977 the effects would have grown to 1.8 percent for the inflation rate and 0.6 for the unemployment rate.

Other policies could offset the effects of decontrol. Removal of the import fee or a lower OPEC price increase would reduce the assumed price of imported oil and hence the level to which the domestic price would rise as a result of decontrol. A slower, phased-in decontrol would have a smaller immediate impact on prices. Tax offsets such as a windfall profits tax combined with a rebate to consumers could offset some of the adverse effect on unemployment.

* * * * * *

We hope these estimates of the economic effects of various economic policies prove useful illustrations of some of the important decisions and general orders of magnitude involved in framing the second Concurrent Resolution on the budget. In keeping with CBO's mandate to provide non-partisan analysis of policy options, we do not recommend one strategy over another. As the markup draws closer and more data on the economy becomes available, we will be able to provide additional information on the projected deficit and estimates of the probable effect of specific policies of interest to the Congress.