STATEMENT OF

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BEFORE THE

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I am pleased to be here today to discuss the general economic context of the Administration's budget proposals and, more specifically, the effects that the proposals would have on programs that fall within this Committee's jurisdiction.

The Economic Outlook

The Administration has proposed dramatic changes in government policies designed to reduce inflation, stimulate economic growth, and reverse the increase in the federal government's share of national output. The Administration and the Congressional Budget Office (CBO) agree on the general direction we expect the economy to take in the next few years, if these proposals are enacted. After sluggish growth and continued high inflation in 1981, we both expect growth to increase and inflation to decline. We differ, though, in how quickly we expect the economic picture to improve. Table 1 presents the economic projections of the Administration, together with an alternative set prepared by the CBO. Both projections incorporate the tax and spending changes proposed by the Administration, but the CBO projection shows slower improvement in inflation, higher interest rates, less rapid real growth (especially in the near term), and higher unemployment than forecast by the Administration.

The CBO's less optimistic outlook on inflation is based on the postwar experience that, once started, inflation builds up great momentum that can persist even through a recession. In part, this momentum is sustained by the ability of many wage earners to get wage increases that compensate them for the rapid inflation that has already occurred, regardless of the state of the labor market. Since labor costs account for roughly three-quarters of total business costs, wage increases that outrun productivity put strong

TABLE 1. ALTERNATIVE ECONOMIC PROJECTIONS (By calendar year)

	1981	1982	1983	1984	1985	1986
GNP (percent change, year over year)						
Administration	11.1	12.8	12.4	10.8	9.8	9.3
CBO Alternative	11.8	11.9	11.5	11.4	11.7	10.9
Real GNP (percent change, year over year)						
Administration	1.1	4.2	5.0	4.5	4.2	4.2
CBO Alternative	1.3	2.5	2.7	3.0	3.8	3.7
GNP Deflator (percent change, year over year)						
Administration	9.9	8.3	7.0	6.0	5.4	4.9
CBO Alternative	10.3	9.2	8.6	8.1	7.5	7.0
CPI (percent change, year over year)						
Administration	11.1	8.3	6.2	5.5	4.7	4.2
CBO Alternative	11.3	9.5	8.9	8.2	7.7	7.1
Unemployment Rate (percent, annual average)						
Administration	7.8	7.2	6.6	6.4	6.0	5.6
CBO Alternative	7.8	7.8	7.8	7.7	7.5	7.2
3-Month Treasury Bills (percent, annual average)						
Administration	11.1	8.9	7.8	7.0	6.0	5.6
CBO Alternative	12.6	13.7	11.5	10.2	9.7	9.3

NOTE: An explanation of the CBO projection and the assumptions on which it is based may be found in the CBO report, Economic Policy and the Outlook for the Economy (March 1981), Chapters IV and V.

upward pressure on prices. This has been exacerbated by increases in food and energy prices.

Restrictive monetary and fiscal policies have been able to slow the momentum of inflation only gradually--and with a significant loss of production and employment in the interim. Last year, for example, relatively tight money, record high interest rates, and credit controls helped induce the seventh postwar recession. But there was little immediate beneficial impact on inflation since wage increases accelerated. The average hourly earnings index rose by 10 percent from January 1980 to January 1981, up from an 8.0 percent gain a year earlier, even though the number of unemployed increased by 1.3 million.

Any economic forecast is subject to a wide margin of error. A forecast today is made especially uncertain by two factors: the large size of the fiscal policy changes proposed by the Administration, and the possibility that--in a period of stagflation--past experience may be a misleading guide to the future.

The performance of the economy could prove to be better over the next few years than the CBO projection for several reasons. First, the budget changes--especially the personal tax cuts--could have a greater impact on total productive capacity than historical experience suggests. Second, the tight monetary policy--by operating directly on price expectations--could induce a quick slowdown in inflation with little loss of production and jobs. Third, promised regulatory changes could reduce inflation and encourage more investment and growth.

On the other hand, the next five years could be worse than historical experience suggests. We could have substantial increases in world commodity prices--especially for oil and food--as a result of unrest in the Middle East, poor weather, or some other factor beyond our control. Also, the Administration's policies do not allow for secondary effects of the proposed budget cuts. For example, if state and local governments increase their sales or property taxes to offset lost federal grants, the CPI would be notched up higher than projected.

CBO has reestimated the Administration's projected budget for coming years. We project that the deficit may be \$65 to \$70 billion in fiscal year 1982--more than \$20 billion higher than estimated by the Administration (see Table 2). And the budget would still be in deficit by fiscal year 1984--perhaps by nearly \$50 billion.

TABLE 2. CBO ESTIMATES OF BUDGET TOTALS BASED ON ADMINISTRATION TAX AND SPENDING PROPOSALS (By fiscal year, in billions of dollars)

	1981	1982	1983	1984
Revenues				
Administration	600	650	709	771
CBO	599	654	707	769
Outlays				
Administration	655	695	732	770
CBO	662	721	766	818
Surplus or Deficit(-)				
Administration	-55	-45	-23	1
CBO	-63	-67	-59	-49

NOTE: An explanation of the CBO budget estimates may be found in Economic Policy and the Outlook for the Economy, Chapter III.

The Administration's Proposals

The Administration's proposals involve a fundamental shift in federal fiscal policy. Growth in federal spending would be held to 6 percent per year over the next three years, compared with a compound annual rate of growth of about 13 percent since 1977 (see Table 3). As a result, federal spending (in direct outlays) as a share of gross national product would decline from 23 percent in 1981 to just over 19 percent by 1984.

TABLE 3. FEDERAL BUDGET TRENDS (By fiscal year)

	Actual[a]	Administration Estimate			
	1977-1980	1981	1982	1983	1984
Percentage Growth					
Revenues	13.3	15.4	8.3	9.0	8.7
Outlays	12.9	13.0	6.1	5.3	5.2
Defense	11.7	19.3	16.5	19.7	13.1
Nondefense	13.3	11.1	2.7	-0.1	1.7
Social safety net	11.0	17.6	8.8	8.9	7.9
Other[b]	15.4	0.8	-6.3	-14.2	-8.5

a. Compound annual rates.

b. For 1983 and 1984, the estimates assume that budget savings not yet identified continue to be in the "other" category.

Not all areas of the budget would be affected the same way, however. Defense spending would increase--by 8 percent per year in real terms between 1980 and 1984. And several nondefense programs that have been expanding rapidly would be largely exempted from spending reductions--including basic Social Security benefits for the elderly, Medicare, railroad retirement, unemployment insurance, Supplemental Security Income, and certain veterans' benefits.

If we are to increase defense spending, meet our obligations to pay interest on the national debt, and exempt the "social safety net" from spending reductions, there must be large cuts in the remaining 30 percent of the budget in order to reach the Administration's spending targets. Many of these remaining programs (including education, employment and training, and nutrition) fall within this Committee's jurisdiction. In all, the Administration proposes cutting programs within Education and Labor's jurisdiction by roughly $15 billion in 1982, which represents about one-third of the total proposed reductions.

In responding to the Administration's specific proposals, the Committee faces a difficult set of decisions. Some programs may have to be pared down, retargeted, or eliminated in order to control federal spending. The problem is that these programs provide benefits to people, some of whom would be hurt. Moreover, some proposals to reduce spending could have serious, unintended consequences.

Education. In the education area, the Administration proposes two major types of reductions:

- o Directing assistance toward the most needy students and their families; and
- o Consolidating various categorical programs, combined with substantially less overall funding.

The proposed cuts in federal student assistance are one example of the Administration's overall effort to focus federal aid on the most needy. With limited total funding for student assistance, continued rapid growth in the untargeted Guaranteed Student Loan (GSL) program, which is an entitlement, would force reduced funding for need-based student assistance programs.

The Administration proposes to reduce GSL program costs in three ways--by limiting borrowing to the amount of students' assessed financial needs, by eliminating the in-school interest subsidy currently paid by the federal government, and by eliminating federal interest subsidies on parent loans. These changes would be responsive to concerns that the program is being used, perhaps even abused, by higher-income students who do not need the loans. The CBO estimates that this proposal would save approximately $100 million in fiscal year 1981 and $900 million in fiscal year 1982--approximately 15 percent more than the Administration's savings estimates, in part because the CBO forecasts higher interest rates.

One risk, however, is that the proposed changes could make the GSL program less attractive to lenders and, hence, make loans less available even to genuinely needy students. Limiting borrowing to the amount of assessed need would reduce lenders' yields. This is because administrative costs for each loan would increase slightly, while at the same time lenders would receive lower federal special allowance payments on the smaller loans. The neediest students would probably be affected the most because they are least likely to have established banking relationships and are viewed as high-risk borrowers.

The Administration also proposes changing the Pell Grant program so as to direct assistance to the most needy of the currently eligible students. Nevertheless, in inflation-adjusted terms, awards for the most needy students would fall considerably behind previous levels. In fiscal year 1981, approximately 250,000 fewer students would receive grants, the average award would be reduced by about $150 (a 14 percent decrease), and program costs would decline to $2.4 billion. In fiscal year 1982, 575,000 fewer students would receive grants, keeping program costs to $2.5 billion.

The Administration's second major approach to restructuring the federal role in education would consolidate categorical programs for elementary and secondary education into two block grants, while reducing funding substantially. Funding for fiscal year 1982 would be 28 percent less in real terms than the level included in the 1981 continuing resolution.

Consolidation could have a number of positive effects, such as lowered administrative costs and greater efficiency in delivering services. The plethora of categorical grant programs that now exist reflects several decades of federal concern with specific aspects of education, and some programs may have achieved their objectives or outlived their original purposes. In addition, the capacity of state and local educational authorities to administer programs effectively may be greater now than when many of these programs were instituted. Consequently, if the categorical programs were consolidated into block grants, state and local agencies would be able to tailor their use of federal funds to meet specific current needs.

Block grants must, however, be structured carefully to avoid adverse or unintended consequences. There is no guarantee, for example, that administrative costs would fall, particularly in the short run. In addition, it is likely that funds would no longer be focused as directly on specific groups of students (such as the disadvantaged) or be used to provide certain services (such as compensatory education), unless restrictions on use of the funds are included in the block grants.

Combining substantial funding reductions with grant consolidation would result in substantial cutbacks in services, unless states and localities were to increase their own financial support. Savings from reduced administrative costs and greater efficiency would not be large enough to offset the magnitude of the reductions proposed by the Administration. Moreover, some school districts with high proportions of poor students would be affected the most, since a third or more of their operating budgets come from the funds that would be consolidated and reduced.

Employment and Training. In the employment and training area, the Administration proposes eliminating public service employment (PSE) programs, on the grounds that they have not generally improved participants' prospects for getting unsubsidized private-sector jobs. And indeed, what little evidence is available suggests that PSE increases participants' post-program earnings by only a small amount, particularly in relation to the high cost of providing these jobs. Furthermore, the PSE program that was designed to provide jobs during periods of high unemployment appears, in fact, to help primarily the structurally unemployed.

The Administration's proposal would eliminate all PSE jobs by the end of fiscal year 1981--about 315,000 full-year equivalent jobs for the economically disadvantaged. Only about one-half of the current PSE participants would have to be fired, laid off, or absorbed by sponsoring agencies--the remaining half would leave through normal attrition. Moreover, the reduction in total employment would be less than the cut in PSE jobs. Depending on the extent of fiscal substitution, the net job loss to the economy would be between 160,000 and 250,000 in fiscal year 1982, compared with 315,000 fewer PSE jobs.

The overall savings for the federal budget would be somewhat less than the reduction in spending for PSE jobs. Spending for public assistance and food stamps would increase, and revenues from Social Security payroll taxes and federal income taxes would decline. Preliminary estimates indicate that federal spending might increase by 3 to 5 percent of the total PSE cost, while federal revenues might decline by 6 to 10 percent of the total PSE cost. Unemployment insurance would also be affected, but estimates are not yet available.

The Administration also proposes eliminating two untargeted youth employment programs, consolidating others with the adult training programs, and reducing overall funding for training by 30 percent. These changes are designed to provide assistance for those who need it most and to decrease administrative costs. Although the effects of the consolidation and the decrease in funding would depend on state and local decisions, youth would probably receive fewer services because their needs differ from those of adults, making them harder to serve in conventional programs. One way to reduce the potential negative effect on youth would be to legislate changes specifically designed to accommodate them in the adult programs.

Child Nutrition. The Administration's proposal to reduce funding for the child nutrition program is another example of directing assistance to the most needy. Available evidence indicates that these programs actually increase nutritional levels only for children from families with very low incomes. The Administration's proposal would continue funding for this group--about 15 million children from poor families--but stop assisting 14.5 million middle- and upper-income students. These changes would reduce federal costs by 35 to 40 percent in fiscal year 1982.

While these reductions would eliminate subsidies for the least needy students, they could unintentionally affect some of the most needy because some schools might drop the programs. If many of the students who would be required to pay more were to drop out of the programs, some schools might have difficulty continuing to finance them. Indeed, school districts that are near their legal taxing limits would find it virtually impossible to provide any financial assistance necessary to continue the nutrition programs. One possible response would be to phase in the cuts so that school districts would have more time to adjust.

In conclusion, this Committee faces a difficult set of decisions as the Congress moves to control the rapid increase in federal spending. The Congressional Budget Office stands ready to assist you in any way we can as you work to translate the Administration's proposals into a plan of action for the Congress.