

Statement of Alice M. Rivlin
Director, Congressional Budget Office
before the
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Mr. Chairman and Members of the Committee:

During the first two years of the new Congressional budget process, Congress has left its firm imprint on the overall budgets for 1976 and 1977.

In my statement this morning I would like to cover four topics which you will be considering as you determine an initial set of targets for the 1978 budget. The first is the current economic situation and prospects for the remainder of this year and 1978. The second is the economic impact of the 1978 budget submitted by President Carter last week. The third topic is reconciling the goals of a low unemployment rate, a low inflation rate, and a balanced budget in the long run. Finally, I will touch briefly on the budget as an instrument for allocating public resources.

THE ECONOMIC OUTLOOK

Although cold weather cut sharply into production and employment in January and February, the outlook for the rest of 1977 is for resumption of economic growth at a rate faster than the disappointing last half of 1976. Contributing substantially to this outlook is the economic stimulus package embodied in the new budget resolution for fiscal year 1977. By the fourth quarter of this calendar year, we project an unemployment rate in the 6.7 to 7.4 percent range, well below the 7.9 percent of the last quarter of 1976. The rate of consumer price inflation during 1977 (fourth quarter to fourth quarter) is estimated at 5.5 to

6.8 percent, a little worse than the rate during 1976 when declining food prices pulled down the aggregate, but far better than the double-digit rates of 1974. These projections are summarized in Table 1.

Besides the fiscal stimulus package, some of the factors contributing to this favorable outcome are interest rates still close to their recession lows in spite of recent increases, ample availability of mortgage funds, and generally low inventory-to-sales ratios which should lead to several quarters of high inventory investment. Demands for new plant and equipment and for exports (in constant dollars) are projected to grow somewhat less rapidly than in earlier recoveries. State and local purchases are also assumed to grow much more slowly than in the past except when they are boosted by federal grants.

Growth during 1977 may well follow a highly irregular quarter-to quarter pattern. A rebound from the weather-caused reductions and a move toward rapid inventory accumulation are very likely with double-digit rates of growth in real GNP or industrial production in the spring a distinct possibility. Last year many forecasters, including those at CBO, were misled by a similar inventory swing in the late winter and spring and failed to anticipate the return to a slower rate of recovery later in the year. We may need to guard against making a similar error this year.

For 1978 prospects at this early date are for less growth than in 1977. We anticipate a rate of real growth in the range of 3.5 to 5.5 percent (fourth quarter to fourth quarter),

TABLE 1. ECONOMIC PROJECTIONS BASED ON THE THIRD CONCURRENT RESOLUTION

| Economic Variables | L e v e l s | | | Rates of Change (percent) | |
|--|--------------------|--------------|--------------|---------------------------|---------------------|
| | 1976:4 (actual) | 1977:4 | 1978:4 | 1976:4 to 1977:4 | 1977:4 to 1978:4 |
| GNP (billions of current dollars) | 1744 | 1910 to 1970 | 2075 to 2205 | 10.0 to 13.0 | 8.0 to 12.5 |
| GNP (billions of 1972 dollars) | 1280 | 1335 to 1365 | 1390 to 1440 | 4.8 to 6.3 | 3.5 to 5.5 |
| General Price Index (GNP deflator, 1972 = 100) | 136 | 142 to 145 | 149 to 155 | 4.8 to 6.3 | 4.5 to 6.5 |
| Consumer Price Index (1967 = 100) | 174 | 183 to 186 | 191 to 197 | 5.5 to 6.8 | 4.5 to 6.5 |
| Unemployment Rate (percentage points) | 7.9 | 6.7 to 7.4 | 5.8 to 6.8 | -- | -- |



compared to 4.8 to 6.3 for 1977. The stimulus package adds about 1 percent to the rate of growth in 1977 and reduces the unemployment rate by about 0.5 percentage points by the end of the year. During 1978, however, the stimulus package serves in large part to preserve the gains made during 1977. Inventory demands are likely to slow down during 1978 as well.

It is possible that a substantial plant and equipment boom or a surge of exports would offset these retarding forces. But it is equally possible that the rate of increase of consumer spending could slow down somewhat or that housing activity could level off or decline. 1978 will be the third year of recovery from the 1973-75 recession, and the historical record warns us to look for signs of weakness or stagnation by that stage of the recovery process.

If the economy does follow the projected path shown in Table 1, then by the end of 1978 we will still be faced with large amounts of idle labor and capital. The projected unemployment rate of 5.8 to 6.8 percent is well above the prerecession rate of 4.9 percent. Excess capacity margins, in contrast, are not exceptionally large, since capacity growth has been limited by lagging spending on plant and equipment. Nevertheless, a study of probable demands and capacity for five groups of major industrial materials suggests that we will not face widespread materials shortages between now and the end of 1978. We cannot dismiss the possibility of recurrence of energy bottlenecks arising from a hot summer, another cold winter, or other unusual

developments. Utilization rates in other industries may rise quite rapidly in the spring of this year if there is substantial inventory rebuilding following the cold weather. After that, however, there should be very little if any further increase in pressure on materials capacity. Furthermore, with the slow growth being experienced by other industrial countries, there should be capacity margins abroad available to relieve any materials shortages here.

Under these circumstances we do not foresee any large-scale acceleration in the rate of inflation. The unusual weather patterns this winter will probably add 0.5 to 1.0 percentage points to the rate of inflation in consumer prices in 1977, led by food and natural gas prices. Barring continued special commodity developments, however, it seems unlikely that by the end of 1978 we will be in a demand position sufficiently tight to cause the overall inflation rate to move upward significantly.

THE ECONOMIC IMPACT OF THE CARTER ADMINISTRATION
1978 BUDGET

The budget submitted by President Carter last week calls for outlays of \$459.4 billion and revenues of \$401.6 billion during fiscal year 1978. The outlays are \$19 billion higher than the proposal submitted by the Ford Administration in January. Most of this difference is due to the economic stimulus package submitted earlier and to restorations of proposed reductions in the Ford budget. Carter Budget outlays appear to be about the same as current policy outlays based on the Third Concurrent Resolution on the 1977 Budget.

Increases above current policy for fiscal year 1978 are proposed by President Carter in defense procurement, petroleum storage, foreign aid, highway construction and railway assistance, and postal subsidies. Decreases below current policy are proposed for hospital reimbursements and water resources. A complete comparison of the Carter budget with a new set of current policy estimates will be available from the CBO in a few days.

Overall, the Carter 1978 budget should not cause any significant departures from the economic projections shown in Table 1, which assume enactment of the economic stimulus proposals in the third concurrent resolution for fiscal year 1977. The new proposals in the budget--those other than the stimulus proposals--are likely to have a slight expansionary effect, but no more than a quarter of a percent of GNP by the end of 1978.

RECONCILING BUDGET GOALS

Since 1975, the first year of the new budget process, the economy has made substantial albeit irregular progress toward two major goals, a low unemployment rate and a low inflation rate. The unemployment rate reached 9 percent at the bottom of the 1975 recession and is now probably in the neighborhood of 7.5 percent. Congressional fiscal policy made a major contribution to this reduction in unemployment. The rate of inflation in consumer prices dropped from 12 percent in 1974 to a current underlying rate in the neighborhood of 6 percent. This reduction was mainly due to the changing behavior of food and fuel prices.

The federal deficit, however, has not come down. It rose from \$45 billion in fiscal year 1975 to \$67 billion in fiscal year 1976, and the third concurrent resolution calls for a slightly larger deficit, just under \$70 billion, for fiscal year 1977. Are these continuing high deficits merely a matter of pump-priming, a temporary necessity to get the recovery firmly underway; or are they a continuing requirement for a sustained recovery and a declining unemployment rate?

It would be foolish to pretend to any certainty about the answer to this critical question. It would be equally foolish not to ask what can be said about the relationship among the goals of a balanced budget, low unemployment and low inflation. The CBO Annual Report to the Budget Committees, submitted on February 15, included a discussion of the relationship among these goals which I would like to summarize in my statement this morning.

The answer to the question of whether declining unemployment and a growing economy are compatible with moving toward a balanced federal budget depends to a large extent on the strength of demand in the nonfederal sectors of the economy. If consumer spending rates are high and private investment is vigorous a healthy rate of economic growth can be maintained with minimal stimulus from the federal budget. On the other hand, if consumer spending rates are weak and private investment is sluggish, continuing federal stimulus will be necessary to keep the economy growing. Prospects for a balanced budget will then be diminished.

The compatibility of a balanced budget with high economic growth, moreover, depends heavily on what growth rate is desired. More federal stimulus will be required to reach a high overall growth rate than to reach a low one.

A brief summary of three possible economic and budget paths may give you a feel for the kind of outcomes that are to be expected under different assumptions and goals. In all three, we assume that new federal spending initiatives add \$10 billion to the current policy budget in each year after 1978. Increases of this size could be used to support new initiatives in energy programs, welfare reform, defense, health care, or any other of the budget functions. Additional economic stimulus necessary to reach the economic goals would take the form of tax cuts. Outcomes under the three paths are summarized in Table 2.

The first, most favorable alternative, is one in which an unemployment rate of 4.5 percent in 1981 is the goal and in which nonfederal demands are exceptionally strong by historical standards. Strong nonfederal demands take the form of high consumer spending rates out of disposable income, a substantial fraction of GNP devoted to investment and fairly high growth in state and local spending and exports.* Under these assumptions the deficit would fall to \$0.2 billion by 1981. The inflation rate

*The detailed assumptions upon which these projections are based are described in a forthcoming CBO paper: Closing the Fiscal Policy Loop: A Long-Run Analysis.

TABLE 2. UNEMPLOYMENT, INFLATION, AND BUDGET SURPLUS OR DEFICIT, 1976 AND 1981 (fiscal years)

| | 1976 | 1981 |
|---|-------|-------|
| <u>Path 1: 4.5 Percent Unemployment Goal, Strong Nonfederal Demands</u> | | |
| Unemployment rate (percentage points) | 8.0 | 4.5 |
| Inflation rate (percent increase from previous year, Consumer Price Index) | +7.1 | +5.2 |
| Required surplus (+) or Deficit (-) | -66.5 | -0.2 |
| Federal spending as a percent of GNP | 22.6 | 21.0 |
| <u>Path 2: 4.5 Percent Unemployment Goal, Moderate Nonfederal Demands</u> | | |
| Unemployment rate (percentage points) | 8.0 | 4.5 |
| Inflation rate (percent increase from previous year, Consumer Price Index) | +7.1 | +5.2 |
| Required surplus (+) or Deficit (-) | -66.5 | -70.3 |
| Federal spending as a percent of GNP | 22.6 | 21.0 |
| <u>Path 3: 5.7 Percent Unemployment Goal, Moderate Nonfederal Demands</u> | | |
| Unemployment rate (percentage points) | 8.0 | 5.7 |
| Inflation rate (percent increase from previous year, Consumer Price Index) | +7.1 | +4.6 |
| Required surplus (+) or Deficit (-) | -66.5 | -2.6 |
| Federal spending as a percent of GNP | 22.6 | 22.3 |

NOTE: The 1981 projections in this table are taken from Tables 7 and 10, pp. 28 and 34, of Budget Options for Fiscal Year 1978: A Report to the Senate and House Committees on the Budget, Congressional Budget Office, February 1977. The projections assume additions to current policy federal outlays of \$10 billion per year beginning in 1979. Any additional fiscal stimulus needed to achieve the assumed economic growth path is achieved through tax cuts.

although still at 5.2 percent in 1981, would begin to accelerate in this alternative. In other words, with strong federal demand the goals of low unemployment and a balanced budget, could both be attained although inflation would continue to be a concern.

The second possible set of outcomes assumes that nonfederal demands are only moderate--that is, propensities to spend are more in line with the historical experience of the last decade. Under these circumstances, pursuing the same unemployment goal would require a continuing federal deficit. Meeting the unemployment goal is still feasible, but it would take periodic large tax cuts to coax households and businesses to spend enough to reach the goal. As Table 2 shows the projected deficit under this alternative is \$70.3 billion in 1981. Low unemployment is not compatible with a balanced budget in this case.

The final path is, like the preceding one, based on the assumption of moderate nonfederal demands but assumes a lower growth rate and therefore an unemployment rate which falls only to 5.7 percent by 1981. By sacrificing the low unemployment goal it is again possible to move toward a balanced budget. The projected deficit in 1981 would be \$2.6 billion. The rate of inflation would not accelerate in this case, but the higher unemployment rate implies more than a million additional unemployed persons than under the vigorous growth assumptions.

CBO's latest 5-year economic paths, the basis for 5-year budget projections now in preparation, assumes an unemployment rate of 5.1 percent in fiscal year 1981, midway between the two assumptions above. If nonfederal demands likewise fall between

the two assumptions above, then this path should be compatible with moving toward a balanced budget. Weak nonfederal demands would mean that continuing deficits would be needed to achieve this path, while strong nonfederal demands would permit either a surplus or a lower unemployment rate and a balanced budget.

Clearly, the strength of nonfederal demands--prior to stimulus from tax cuts--is a key to whether the long-run goals of the budget process are compatible or not. In the analysis above, alternative assumptions were made about nonfederal demands without any consideration of what circumstances might cause these demands to be strong or weak. It is appropriate to supplement this analysis with some discussion of possible influences on the strength of nonfederal demands.

One important influence is monetary policy. Rapid monetary expansion can contribute to growth in new housing or in plant and equipment and thereby make the "strong nonfederal demands" path more likely. There are, however, dangers in too rapid monetary expansion. The effects of monetary policy take a long time to work themselves out, and a policy which contributes to low unemployment in the years immediately ahead may contribute to significantly higher inflation rates in later years.

Another potent force in the strength of nonfederal demands is the confidence of businesses and households in their economic future. Lack of confidence reduces the willingness of businesses to invest and causes households to be more cautious about making

spending commitments. Unfortunately, our understanding of the determinants of confidence is very sketchy. It is appealing to believe that a firm federal commitment to steady growth accompanied by policies to reduce sharp fluctuations in food and other commodity prices would strengthen confidence; but we cannot be at all sure how much difference any specific policy action would make.

The area of government regulation is a third one with great potential impact on the strength of nonfederal demands. Government regulation over private economic decisions is undertaken to further important national goals such as pollution abatement or product safety. Complex or inefficient regulations or uncertainty about future changes in regulations, however, can hold back private production through raising costs or through limiting profitability. Calculating the effects of any one regulatory action, once again, is highly problematic.

It is difficult, in summary, to derive any specific policy proposals or even any general guidelines which are certain to influence the strength of nonfederal demands. A variety of measures to strengthen private demands will be valuable in helping meet budget goals. Until we know much more than we do about what these measures might be, however, we will have to reckon with a strong possibility that there will be difficult choices to be made among goals in the years ahead.

BEYOND FISCAL POLICY

Mr. Chairman, I have as the Committee requested devoted my attention this morning to the budget as an instrument of fiscal policy, especially to the interrelation between budget deficits and the level of aggregate economic activity. This is an important aspect of budget making, but it is probably not the most important.

The budget is not only an instrument for fiscal policy, it is also an instrument for allocating resources among competing public needs, for deciding what activities should be carried out by the federal government, and how they should be financed. As the Committee formulates its First Concurrent Resolution on the 1978 Budget, you will be making decisions that involve weighing the relative importance of increasing military preparedness versus financing additional health care, of encouraging development of new energy sources versus increasing welfare or food stamp benefits for the very poor; of improving mass transit in major cities versus encouraging the construction of additional housing; of raising revenue through payroll taxes versus raising it through income taxes; and of increasing public capital such as dams and roads and public buildings versus increasing opportunities for private investment. These decisions flow from different philosophies about the size and role of the federal government. They should not be mixed up with the decisions about fiscal policy. Whatever degree of fiscal stimulus from the federal budget the Congress regards as appropriate can be achieved with a variety of sizes and mixes of federal spending.

I would encourage you as you make these important programmatic decisions over the next few weeks, to look beyond fiscal year 1978 and consider the desirable size and composition of the federal budget over the next several years. The budget for the next fiscal year is heavily determined by past history and cannot realistically be changed in dramatic ways. However, some of the apparently small decisions that you will be making in setting the fiscal year 1978 budget can have major consequences for the size and composition of program spending in future years. Some of those decisions and their future implications are discussed in the Congressional Budget Office's Annual Report to this Committee submitted on February 15, and at greater length in our series of budget issue papers. Mr. Chairman, we, of course, stand ready to help the committee in any way we can as you consider the fiscal year 1978 budget and its future implications, function by function.

