Statement of Alice M. Rivlin
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before the
Joint Economic Committee
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Mr. Chairman and Members of the Committee:

This morning we are releasing our report on Five-Year Budget Projections: Fiscal Years 1979-1983. I ask permission that the report be entered in the record.

The primary purpose of CBO's current policy projections is to provide a neutral baseline for evaluating the effects of new proposals on the long-run size and shape of the budget. As you know, the projections are estimates for five years ahead of federal spending and revenues under current policies, adjusted for demographic and economic changes in those five years. The impact of new legislation on spending or revenues can be added to or subtracted from this current policy base. This year, in addition to estimating the effects of economic change on the budget, CBO has made estimates of the amount of additional spending or tax cuts likely to be required to sustain for five years the economic growth objectives adopted in the Second Concurrent Resolution on the Budget for Fiscal Year 1978.

My testimony today will focus on three areas: (1) a summary of the CBO current policy projections of receipts and outlays; (2) estimates of the tax cuts or spending increases that would be required if the economy were to continue to grow at the rates assumed in the second concurrent resolution; and (3) a brief discussion of how five-year projections might be useful in the formulation of multiyear budgetary targets.

## CURRENT POLICY PROJECTIONS

### Economic Assumptions

Inflation, unemployment, and other levels of economic activity have a major effect on revenues and outlays; hence, projections require assumptions about the state of the economy during the projection period. In the CBO report, Five-Year Budget Projections: Fiscal Years 1979-1983, the major economic assumption is a continuing recovery with declining unemployment. The economic assumptions for 1977 and 1978 are taken from the conference report on the second concurrent resolution on the budget. The assumptions for 1979 through 1983 represent an extrapolation of the economic growth objective for 1978 contained in the conference report, with real economic growth -- as measured by the rate of growth in the gross national product (GNP) in constant dollars -- holding at about 4.8 percent through 1982 and dropping to 3.7 percent in 1983 as the unemployment rate reaches 4.5 percent.

The economic assumptions for 1979 through 1983, which are shown in Table 1, should be viewed as one of many possible long-run targets for the economy. The rate of growth is optimistic by historical standards, but not unrealistic.

### Budget Implications of Economic Assumptions

Under these assumptions, current policy receipts would rise faster than outlays. Projected receipts increase from $457 billion in fiscal year

TABLE 1. AGGREGATE ECONOMIC ASSUMPTIONS: BY CALENDAR YEARS

| Selected Economic Variables | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|---|---|
| Gross National Product (GNP) | | | | | | | |
| Current dollar GNP (in billions of dollars) | 1,898.0 | 2,107.0 | 2,333.8 | 2,582.2 | 2,853.9 | 3,156.4 | 3,465.2 |
| Real GNP (in billions of 1972 dollars) | 1,338.0 | 1,402.7 | 1,467.9 | 1,538.4 | 1,612.2 | 1,688.3 | 1,751.4 |
| Growth rate of real GNP | 5.0 | 4.8 | 4.7 | 4.8 | 4.8 | 4.7 | 3.7 |
| Unemployment Rate (percent) | 7.0 | 6.5 | 6.2 | 5.7 | 5.2 | 4.7 | 4.5 |
| Consumer Price Index (percent change) | 6.5 | 5.6 | 6.0 | 5.7 | 5.5 | 5.7 | 5.9 |

1979 to $751 billion in 1983. As a percent of GNP, current policy receipts would increase from 20 to 22 percent. Current policy outlays would rise from $495 billion in fiscal year 1979 to $655 billion in fiscal year 1983, declining from 22 to 19 percent of GNP. The disproportionate rise in receipts as compared with outlays occurs because of the progressive nature of individual income taxes.

The receipts the government would be taking out of the economy would rise much faster than the outlays it would be putting back into the economy in the form of wages, purchases, and payments to individuals. Hence, if current policies are followed unchanged during the next five years, the federal budget would exert a restrictive influence on the economy. Consequently, for the optimistic assumptions for economic growth to be realized, fiscal and monetary policies would have to be used to offset the fiscal drag exerted by the projected current policy budgets.

## PROJECTED FISCAL DRAG OFFSETS 1/ AND DEFICITS

As a new feature of this year's five-year projections report, estimates have been included of the approximate amount in tax cuts or spending increases that would be needed to offset the fiscal drag. The size of the needed federal offset depends, of course, on the strength of nonfederal demand -- namely, consumption, investment, state and local government purchases, and net exports. Stronger nonfederal demand would decrease the tax cuts and spending increases needed to achieve the assumed growth path, whereas weaker nonfederal demand would increase the necessary offset.

For the five-year projections report, CBO assumed a scenario for nonfederal demand that is moderate by historical standards -- stronger than the average of the post-World War II years, but somewhat weaker than the peak period of 1961 through 1966. Using this assumption for nonfederal demand, roughly $115 billion in additional budget stimulus -- namely, tax cuts or spending increases -- would be needed by fiscal year 1983 to offset the fiscal drag implicit in current policy projections of receipts and outlays.

In order to determine what projected federal budget deficit or surplus is consistent with realization of the economic assumptions, this $115 billion that is needed to offset fiscal drag and achieve economic goals must be compared with the current policy margin, which is the amount generated by

1/ "Fiscal drag offset" is defined here as the stimulus needed to achieve the desired economic goals, given nonfederal demands.

the excess of current policy receipts over outlays. As long as the fiscal drag offset is greater than the current policy margin, the budget is projected to remain in deficit. As shown in Table 2, this would happen throughout the five-year period under the moderate assumption about nonfederal demand. By fiscal year 1983, the projected deficit would have declined to $19 billion, but the budget would still not be in balance.

TABLE 2. FIVE-YEAR BUDGET PROJECTIONS: BY FISCAL YEARS, IN BILLIONS OF DOLLARS

| | 1978 Second Concurrent Resolution | Projections | | | | |
|---|---|---|---|---|---|---|
| | | 1979 | 1980 | 1981 | 1982 | 1983 |
| Current Policy Receipts | 397.0 | 457 | 519 | 590 | 668 | 751 |
| Current Policy Outlays | 458.25 | 495 | 529 | 565 | 606 | 655 |
| Current Policy Margin | -61.25 | -38 | -10 | 25 | 62 | 96 |
| Fiscal Drag Offset | -- a/ | 29 | 51 | 74 | 101 | 115 |
| Deficits (-) or Surplus | -61.25 | -67 | -61 | -49 | -39 | -19 |

a/ It is assumed that the spending ceiling and revenue floor in the second concurrent resolution are consistent with the fiscal stimulus needed for the economy to grow at the rate of 4.8 percent in fiscal year 1978. If more or less fiscal stimulus is required, corresponding adjustments would have to be made in the estimates of the fiscal drag offset for fiscal years 1979-1983.

The scenario just described is a plausible one, but it certainly is not the only possible outcome. If a sustained business investment boom

developed, either spontaneously or in response to expansionary monetary policy, or if growth in economic activity in the rest of the world stimulated U. S. exports, the need to offset the fiscal drag would be smaller and the budget deficit would decline more rapidly. For example, using more optimistic assumptions about nonfederal demand, comparable to the kind experienced in the early 1960s, the required fiscal drag offset would equal the current policy margin by fiscal year 1982 -- which means the budget would be balanced by that date.

On the other hand, if nonfederal demand were to grow very slowly, more expansionary policies and an increasing budget deficit might be needed to reach the assumed output and unemployment goals. For example, under weaker assumptions about nonfederal demand, it might take deficits of $60 billion to $70 billion through fiscal year 1983 just to sustain a 4.0 percent economic growth rate.

## MULTIYEAR TARGETING

As you know, budget resolutions are now adopted by the Congress for one year at a time. Since a large part of any given year's budget is determined by decisions made in prior years, the Congress is each year faced with a budget largely composed of spending and receipts that have not been subject to review within an integrated framework.

As part of its responsibility under Section 502(c) of the Congressional Budget Act of 1974, CBO conducted a study on the feasibility and

advisability of advancing all or some budget decisions so that, instead of making them just before the start of a fiscal year, they would be made at least 12 months in advance. In that study, CBO recommended that the Congress begin formulating advance budget targets, with the eventual goal of annually adopting targets for the budget year and the four following years.

Projections like those found in the report are a useful baseline on which to build plans for future spending and receipts. In addition, estimates of the budget stimulus needed to offset fiscal drag provide a rough idea of how much room will be available for net increases in spending or tax reductions, under various economic assumptions.

Several key questions are involved in setting multiyear targets. What are the goals for the economy and for the deficit? How much should be allocated for tax cuts or spending increases? What should be the level for federal spending and receipts as a percent of GNP?

The CBO five-year projections report suggests that an unemployment rate of 4.5 percent and a deficit of $19 billion might be achieved by fiscal year 1983, assuming an accommodative monetary policy and slightly above average performance by the nonfederal sectors of the economy. In order to balance the budget by fiscal year 1983, however, the performance of the nonfederal sectors would have to be stronger than that. On the other hand,

if the initial assumptions about nonfederal demand were borne out, but a more optimistic goal were set for the unemployment rates, the budget stimulus required would be greater than that estimated here, and the budget deficit would decline more slowly.

In addition to setting goals for the economy and the deficit, the Congress might want to set goals for the level of spending or for the level of receipts in relation to the economy. For example, the Congress might set as a goal the maintenance of a specified level of federal spending as a percent of GNP. At present, spending is 21.2 percent of potential GNP (defined as the value of GNP if the economy were at a 4.5 percent unemployment rate), but current policy projections show the federal government's share of potential GNP falling to 19.3 percent by fiscal year 1983. If the Congress were to set as a goal the maintenance of the current 21.2 percent federal share, a sizable part of the fiscal drag offset alluded to earlier would have to be used for spending increases.

As an alternative to maintaining the current federal share of potential GNP, however, the federal income tax system might be indexed, so that effective rates would not rise because of inflation. This would cut taxes below current policy from year to year, because the progressive income tax system implicit in current policy has a more than proportional response to inflation. As a result, indexing would commit a portion of the fiscal drag offset for these automatic tax cuts. The remainder would be available either for further tax cuts or for spending increases.

The most important decisions in a multiyear targeting process involve program needs and costs. Current policy projections of outlays and revenues provide a neutral base that can be used to frame these decisions.

As indicated in Table 3, the current policy base contains only slight changes from the current distribution among types of federal programs. As a percent of the total, national defense outlays would rise from 24 to 25 percent. Outlays for contributory payments to individuals would grow from 32 to 36 percent, largely because of changes in the number of social security and medicare beneficiaries. Outlays in the form of grants to state and local governments would fall from 12 to 10 percent because of the phaseout of certain countercyclical programs.

TABLE 3. PERCENT OF TOTAL CURRENT POLICY OUTLAYS BY SOURCE: BY FISCAL YEARS

| | 1977 Estimate | 1978 Second Concurrent Resolution | Projections | | | | |
|---|---|---|---|---|---|---|---|
| | | | 1979 | 1980 | 1981 | 1982 | 1983 |
| National Defense | 24 | 24 | 24 | 24 | 25 | 25 | 25 |
| Contributory Benefit Payments to Individuals | 34 | 32 | 33 | 33 | 34 | 35 | 36 |
| Other Benefit Payments for Individuals | 11 | 11 | 11 | 11 | 11 | 11 | 10 |
| Grants to State and Local Governments | 12 | 12 | 12 | 11 | 10 | 10 | 10 |
| Net Interest | 7 | 7 | 7 | 7 | 7 | 7 | 6 |
| Other Federal Operations | 12 | 13 | 14 | 14 | 13 | 13 | 13 |
| TOTAL | 100 | 100 | 100 | 100 | 100 | 100 | 100 |

As indicated in Table 4, greater changes would occur among types of federal receipts. If tax policies were not to change over the next five years, the individual income tax, because of its progressive nature, would account for a greater percentage of total revenue, rising from its current 44 percent of total revenue to 52 percent in 1983. Over the same period, corporate income taxes would account for approximately the same proportion of the total, while social insurance taxes and contributions would fall from their current 31 percent of total receipts to 27 percent in 1983. (If pending social security legislation were enacted, the share of total receipts that are for social insurance taxes and contributions would only decline to 30 percent.)

TABLE 4. PERCENT OF TOTAL CURRENT POLICY RECEIPTS BY SOURCE: BY FISCAL YEARS

| | 1977 Estimate | 1978 Second Concurrent Resolution | Projections | | | | |
|---|---|---|---|---|---|---|---|
| | | | 1979 | 1980 | 1981 | 1982 | 1983 |
| Individual Income Taxes | 43.9 | 44.1 | 46.6 | 48.2 | 49.2 | 50.6 | 51.8 |
| Corporate Income Taxes | 15.4 | 14.9 | 14.7 | 14.6 | 14.6 | 14.2 | 14.1 |
| Social Insurance Taxes and Contributions | 30.4 | 31.3 | 30.0 | 28.9 | 28.1 | 27.8 | 27.0 |
| Excise Taxes | 4.9 | 5.1 | 4.4 | 4.0 | 3.7 | 3.6 | 3.3 |
| Estate and Gift Taxes | 2.0 | 1.4 | 1.3 | 1.3 | 1.4 | 1.2 | 1.1 |
| Customs Duties | 1.5 | 1.4 | 1.3 | 1.3 | 1.4 | 1.3 | 1.3 |
| Miscellaneous Receipts | 1.8 | 1.8 | 1.8 | 1.5 | 1.4 | 1.2 | 1.1 |
| TOTAL | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

The Congress, of course, has the option of modifying the current policy base. Program changes that range from welfare reform to national health insurance to energy legislation could, if enacted, significantly change

the current policy balance among types of programs. In addition, each of the three major tax categories is a likely object of significant revision within the next five years. Changes in social security taxes are currently before the Congress and modifications of the income tax structure that could involve such issues as the integration of the corporate and individual income taxes and incentives for capital formation will probably come before the Congress within the next few years.

These individual program changes will be debated within the context of, and will affect, other Congressional goals -- such as achieving full employment, reducing or controlling inflation, achieving a given magnitude of federal effort, and producing a balanced budget.

A hard fact is that in only the most optimistic scenario of nonfederal demand will the Congress be able to achieve all its desired economic and budgetary goals. Consequently, the Congress will have to face hard tradeoffs among program goals, full employment, and a balanced budget. Although such choices probably cannot be avoided, the Congressional Budget Office believes that they can best be addressed in an advanced targeting framework.