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Before the Committee on the Budget
U.S. House of Representatives

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Mr. Chairman, in 1978, unemployment declined substantially, but inflation accelerated to near record levels for the postwar period. As a result, the Administration and the Federal Reserve have undertaken an anti-inflation program of tightened credit, wage-price guidelines, and proposed spending cuts. As you begin your deliberations on the First Concurrent Resolution on the Budget for Fiscal Year 1980, the central question facing this committee is: How should the budget respond to this anti-inflation effort? To assist your consideration of this question, my statement this morning will cover four topics:

- o The outlook for the economy over the next two years as forecast by CBO;
- o The prospects for slowing inflation;
- o The main outlines of the Administration's proposed budget; and
- o Other fiscal policy options currently receiving attention in the Congress.

THE ECONOMIC OUTLOOK

There are two cross-currents in the economy today that make forecasting especially uncertain. First, economic growth was quite robust at the end of the year. The fourth quarter gains in retail sales, production, and employment were substantial, and the momentum of this increased activity should carry over into early 1979.

Second, the high rate of inflation has planted the seeds of a slowdown in the economy:

- o In response to the increase in prices and the associated depreciation of the dollar, the Federal Reserve has tightened monetary policy. Short-term interest rates are up sharply from mid-1978, and the growth of the money supply has slowed dramatically since last fall. The resulting credit restraint is expected to affect housing and business investment adversely later this year.
- o Rapid inflation apparently has also led to buy-in-advance behavior by consumers. This response is reflected in the record high ratios of consumer debt to income and may be borrowing sales from later in the year.
- o Finally, in part because periods of high inflation are typically followed by recession, consumer and business confidence dropped sharply toward the end of last year. Surveys of business spending plans show relatively weak growth in outlays for plant and equipment in 1979.

There is widespread agreement among forecasters that the outcome of these cross-currents will be a slowdown in the pace of economic activity this year. Differences of opinion concern the timing and severity of the slowdown.

In preparing our forecast, CBO has made two policy assumptions:

- o As usual, the fiscal policy assumption is a continuation of current policy, resulting in estimated federal outlays of \$494 billion in fiscal year 1979 and \$551 billion in fiscal year 1980. Thus, the CBO forecast does not include either the spending cuts proposed by the Administration or its real wage insurance program.
- o Monetary policy is assumed to remain restrictive, with short-term interest rates rising somewhat further and peaking in the second quarter.

As shown in Table 1, CBO forecasts real output to slow significantly, growing at a 0 to 2 percent rate during 1979, with a small

TABLE 1. SUMMARY OF CBO ECONOMIC PROJECTIONS UNDER CURRENT POLICY,
CALENDAR YEARS 1979 AND 1980

Economic Variable	1976:4 to 1977:4 (actual)	1977:4: to 1978:4 (actual)	1978:4 to 1979:4	1979:4 to 1980:4
GNP (current dollars, percent change)	11.9	12.9	7.0 to 11.1	9.7 to 13.9
GNP (1972 dollars, percent change)	5.5	4.3	0.0 to 2.0	3.0 to 5.0
Consumer Price Index (percent change)	6.6	8.9	7.0 to 9.0	6.5 to 8.5
Unemployment Rate, End of Period (percent)	6.6	5.8	6.2 to 7.2	6.2 to 7.2

downturn beginning in the second half of the year. A mild recovery is expected in 1980, with real growth averaging 3 to 5 percent. As a result of the weaker economic activity, the unemployment rate is projected to rise to a 6.2 to 7.2 percent range by the end of this year and to continue in the same range throughout 1980. Meanwhile, inflation is expected to remain stubbornly high. The increase in the Consumer Price Index is forecast to range between 7 and 9 percent this year and between 6.5 and 8.5 percent in 1980.

The prospective recovery in economic activity in 1980 is projected to be relatively mild, because the downturn is not deep and inflation remains high. Consequently, the Federal Reserve is assumed to continue its policy of credit restraint. Furthermore,

federal fiscal policy, even without the Administration's proposed spending cuts, exerts a restraining influence on the growth of total demand next year, as the interaction of inflation and the progressive tax structure causes personal income tax rates to rise. Despite relatively slack labor and product markets, inflation is not expected to moderate significantly in 1980.

THE INFLATION OUTLOOK

Why doesn't inflation slow more quickly? The answer lies in the nature of our economic institutions. If prices are to decelerate, wage increases must be brought more in line with productivity gains and profit margins must not rise. Since compensation per hour rose by more than 9 percent last year, while productivity was virtually unchanged, we clearly have a long way to go to rectify this imbalance.

In the current anti-inflation policy, two approaches are being used to slow this rapid wage growth:

- o First, more restrictive monetary and fiscal policies retard economic growth, and the increased slack in product and labor markets puts downward pressure on prices and wages.
- o Second, a wage-price standards program has been adopted, in order to influence wage and price decisions directly.

Policies that increase unemployment are likely to slow the pace of inflation, but this will not happen quickly. The formal or informal indexing of wages and other income adjustments to past

price increases imparts great momentum to inflation; consequently, a prolonged period of economic slack would be needed to slow the rise of prices and wages significantly. Simulations done by CBO suggest that five years of unemployment at about 7 percent would be necessary--in the absence of outside shocks--to bring inflation down to the neighborhood of 4 percent. Therefore, the attempt to cure rapid inflation with restrictive monetary and fiscal policies alone has considerable costs in terms of lost employment and production. Furthermore, experience shows that these costs are distributed very unevenly over the population.

The other anti-inflation approach--wage-price standards--attempts to slow the momentum of inflation without the cost of lost jobs and output. Even with widespread compliance, however, it is doubtful that this program could slow inflation quickly. Well over half the labor force is explicitly or tacitly exempt from the wage standard, and about 60 percent of the goods and services that compose the Consumer Price Index (CPI) are also formally or tacitly exempt from the price standard. If the prices for these exempt goods and services continue to rise as fast as they did last year, the CPI would increase by 8.75 percent in 1979--even with full compliance from the nonexempt group. And full compliance with the program may be difficult to obtain, especially from labor unions that are being asked to accept reduced real wages for their members.

THE BUDGET

The major issue before this committee is what can fiscal policy do to mitigate inflation? Even if you choose to hold taxes and spending at current policy levels, the budget would most likely exert a mildly restrictive effect on the economy in 1980. If you decide to cut spending below current policy, either moderately as proposed by the Administration or more substantially as recommended by some, fiscal policy will exert more restraint on economic activity.

The Administration's Budget

The Administration proposes to reduce spending growth in fiscal year 1980 in order to complement the anti-inflationary effects of the wage-price program and tight monetary policy. The budget estimates total outlays for 1980 at \$531.6 billion, 7.7 percent above the estimated 1979 level. This contrasts with the 9.5 percent growth in federal spending expected in 1979 and the 11.9 percent growth in 1978.

Another benchmark for comparison is what 1980 outlays would be under a continuation of current spending policies as set forth in the second budget resolution for 1979. CBO estimates that current policy outlays in 1980 would total \$551 billion, or nearly \$20 billion above the President's budget estimate (see Table 2). The Administration's lower spending level reflects both differences in economic assumptions and policy changes.

TABLE 2. THE FEDERAL BUDGET OUTLOOK: BY FISCAL YEAR, IN BILLIONS OF DOLLARS

	1978 (actual)	CBO Current Policy Estimates		Administration Budget Proposal	
		1979	1980	1979	1980
Receipts	402.0	453.3	502	456.0	502.6
Outlays	450.8	493.8	551	493.4	531.6
Deficits	48.8	40.5	49	37.4	29.0

Economic Assumptions and Budget Estimates. The estimates of receipts and outlays in the Administration's budget are based upon economic assumptions that are more optimistic than the CBO economic forecast. As may be seen in Table 3, the Administration's projection of real growth is at the optimistic end of the CBO range for 1979, but at the pessimistic end for 1980. The Administration's projections of both inflation and unemployment, however, are at or near the optimistic end of the CBO range for both years.

The differences in economic assumptions do not produce widely divergent revenue estimates for fiscal year 1980 because the impact of faster real growth in the Administration's forecast is largely offset by its projected lower inflation. The economic assumptions do have a significant impact on spending estimates, however, because both the lower unemployment and lower inflation in the Administration's forecast result in lower spending estimates.

TABLE 3. COMPARISON OF ADMINISTRATION AND CBO ECONOMIC ASSUMPTIONS

Economic Variable	1978:4 to 1979:4	1979:4 to 1980:4
Real GNP (percent change)		
Administration	2.2	3.2
CBO	0 to 2.0	3 to 5
GNP Deflator (percent change)		
Administration	7.4	6.4
CBO	7.0 to 9.0	6.5 to 8.5
Unemployment Rate, End of Period (percent)		
Administration	6.2	6.2
CBO	6.2 to 7.2	6.2 to 7.2

CBO has reestimated the Administration's budget proposals using our own economic assumptions and estimating methodology. On this basis, CBO estimates that receipts would total about \$499 billion, outlays would total \$540 billion, and the budget deficit would be close to \$41 billion. The major CBO reestimates of the Administration's budget are shown in Table 4. On the receipt side, CBO estimates that the real wage insurance proposal could cost as much as \$1 billion more, primarily because of higher inflation rates. CBO also estimates current law revenues at \$2 billion less than the Administration, largely because of differences in economic assumptions.

For outlays, CBO estimates that somewhat higher unemployment and inflation than foreseen by the Administration could add over \$4.5 billion for programs such as unemployment insurance, social

security, food stamps, medicare, and medicaid. Other estimating differences could add about another \$4 billion to the Administration's outlay estimate.

Under the economic conditions forecast by CBO, the committee would have to recommend deeper spending cuts than proposed by the President in order to achieve a budget deficit of under \$30 billion and to hold the growth in outlays to below 8 percent in 1980.

TABLE 4. CBO ESTIMATES OF THE ADMINISTRATION'S FISCAL YEAR 1980 BUDGET: IN BILLIONS OF DOLLARS

Receipts	
Administration's estimate	502.6
CBO Reestimates	
Real wage insurance	-0.9
Other differences	<u>-2.3</u>
CBO estimate of Administration budget receipts	499.4
Outlays	
Administration's estimate	531.6
CBO estimates under	
CBO economic assumptions	
Unemployment insurance	2.3
Social security	0.9
Medicare and medicaid	0.6
Food stamps and other	0.8
Other estimating differences	<u>3.8</u>
CBO Estimate of Administration's Budget Outlays	540.0

Policy Changes. The major policy change for revenues is the Administration's real wage insurance proposal to help achieve compliance with the 7 percent wage guideline. The cost of the real wage insurance depends upon both the rate of inflation and compliance with the President's wage standard. The Administration estimates that the proposal will cost \$2.5 billion (\$2.3 billion in lower receipts, and \$0.2 billion in increased outlays), assuming a 7.5 percent increase in the CPI from the fall of 1978 to the fall of 1979. The Administration's proposal is a novel approach that might contribute to holding down inflation. It should be recognized, however, that, if the program is not fully successful, it might cost more than the Administration estimates. CBO estimates that, if inflation were 8 percent rather than 7.5 percent, the real wage insurance proposal could cost \$3.5 billion.

Although there are a few proposed increases above current policy spending levels (such as lifting the authorization ceiling for food stamps), the most significant feature of the 1980 budget is an absence of new spending initiatives and a general effort to hold existing programs at or below current policy levels. The CBO estimate of current policy outlays for national defense includes 3 percent real growth resulting from past appropriations for weapons procurement. Therefore, the President's proposed 3 percent real growth in defense outlays does not represent a significant change from current policy. However, the budget does propose significant reductions from current policy spending levels

in a number of other areas. As shown in Table 5, the major cuts from current policy are for CETA employment and training programs (\$3.1 billion); medicare and medicaid (\$2.3 billion); federal employee pay raises (\$1.4 billion); Forest Service and other natural resource and environment programs (\$0.9 billion); SBA disaster loans (\$0.8 billion); and farm price supports (\$0.8 billion).

The Economic Impact of Alternative Budget Options

To assist the Congress in its budget decisions, CBO has examined the impact of three anti-inflationary budget options for fiscal year 1980:

- o A \$15 billion cut in spending below current policy, which is larger than the cut proposed by the Administration;
- o A \$25 billion cut in spending; and
- o A \$25 billion spending cut combined with a \$15 billion cut in payroll taxes.

The composition of the spending cuts and rough estimates of the economic impact of these options are shown in Table 6. The estimates reflect the basic observation that spending cuts generate significant employment losses quickly--450,000 jobs after eight quarters for the \$15 billion cut--but the effect of spending cuts on inflation is quite small during the first two years--a 0.2 percent drop in the level of the CPI in the case of the \$15 billion cut. As a result of the lagged response of inflation to fiscal restraint, however, much of the impact on prices would come later,

TABLE 5. CURRENT POLICY OUTLAYS AND ADMINISTRATION'S PROPOSED CHANGES: FISCAL YEAR 1980 IN BILLIONS OF DOLLARS

	CBO Current Policy	CBO Estimate of Administra- tion's Request	Difference
National Defense			
Military and civilian pay raises	3.1	2.2	-0.9
DoD operations and maintenance	38.0	38.9	0.9
Other national defense	84.2	84.3	0.1
Subtotal	<u>125.3</u>	<u>125.4</u>	<u>0.1</u>
Human Resources			
CETA employment and training programs	12.7	9.6	-3.1
Education programs	14.5	13.9	-0.6
Other function 500	7.6	7.3	-0.3
Medicare and medicaid	48.4	46.1	-2.3
Other health programs	9.3	8.9	-0.3
Social security	117.3	116.7	-0.6
Food stamps	6.1	7.5	1.4
Real wage insurance	—	0.3	0.3
Other income security	60.8	60.8	<u>a/</u>
Veterans' readjustment benefits	2.6	2.3	-0.3
Veterans' hospital and medical care	6.4	5.8	-0.5
Other veterans' benefits and services	12.6	12.5	-0.1
Subtotal	<u>298.2</u>	<u>291.6</u>	<u>-6.6</u>
Net Interest	46.0	45.2	-0.8
All Other			
Natural resource and environment programs	12.8	11.9	-0.9
Farm price supports	3.4	2.6	-0.8
Commerce and housing credit	4.1	3.4	-0.7
SBA disaster loans	0.8	<u>a/</u>	-0.8
Antirecession fiscal assistance	0.5	—	-0.5
Civilian agency pay raises	1.4	0.9	-0.5
All other, net	59.0	59.0	<u>a/</u>
Subtotal	<u>82.0</u>	<u>77.8</u>	<u>-4.2</u>
Total	551.5	540.0	-11.5

a/ Less than \$50 million.

TABLE 6. ESTIMATED EFFECTS OF THREE FISCAL POLICY OPTIONS FOR FISCAL YEAR 1980 AFTER EIGHT QUARTERS

Economic Variable	\$15 Billion Spending Cut	\$25 Billion Spending Cut	\$25 Billion Spending Cut and \$15 Billion Payroll Tax Cut
GNP (billions of current dollars)	-28	-46	-32
GNP (billions of 1972 dollars)	-13	-20	-6
Unemployment Rate (percent points)	0.3	0.6	0.3
Employment (thousands)	-500	-900	-500
CPI (percent change from base)	-0.2	-0.4	-0.8

NOTE: The composition of the expenditures reductions are as follows:

<u>\$15 Billion</u>		<u>\$25 Billion</u>	
Transfers	\$7.0	Transfers	\$11.0
Purchases	5.0	Purchases	6.0
Grants	3.0	Grants	8.0
PSE	0.2	PSE	5.3

The disproportionately large impact of the \$25 billion spending cut on employment and unemployment is due to the heavy reduction in public service employment (PSE). Reducing payroll taxes is considered effective in lowering inflation.

if the more austere policies were maintained. The deficit is not reduced by the full amount of the spending cut, because the reduced level of economic activity automatically decreases revenues and increases outlays.

If a larger impact on inflation were desired, while at the same time minimizing the effect on employment, one possible strategy would be to combine the decrease in spending with a reduction in the payroll tax. Because lowering payroll tax rates is believed to have a beneficial effect on inflation even while boosting overall demand, the net economic and budgetary effect of this combination is advantageous. The disadvantage is that it would require financing social security from general revenues.

These options illustrate that the desired size of the federal sector and the appropriate economic stimulus from the budget are separable issues. It is possible to reduce the size of government by cutting spending without creating a restrictive effect on overall economic activity--if such a spending reduction is accompanied by tax cuts.

A lower rate of federal spending is largely achievable by Congressional action, but a lower deficit may not be. For example, if CBO's economic projections turn out to be more nearly correct than those of the Administration, even adoption by the Congress of the Administration's proposed budget would fail to achieve the goal of holding the deficit below \$30 billion. Both revenues and outlays

respond quickly to economic conditions without any action by the Congress. If we have a deep recession, the deficit will rise quickly despite the cuts in spending.

CONCLUSION

There is widespread agreement that inflation is the major economic problem today. There is, however, much less agreement on how to deal with this problem. It is tempting to believe that there must be some simple, costless way to rid ourselves of inflation quickly. Unfortunately, there isn't. While standard restrictive policies can reduce inflation, they can do so only by creating prolonged slack in the economy. Thus, these policies have a high cost in terms of lost jobs and output. Other, more direct attempts to slow down the wage-price spiral, such as incomes policies, are administratively complex and require widespread public support and compliance, which can be very difficult to obtain.

As the committee moves toward the first concurrent resolution, it should keep in mind that control over the budget and the economy cannot be realized unless decisions on the 1980 budget are regarded as only one step in an overall budgetary strategy that may take several years to implement. The shape of the 1980 budget will significantly affect the outlook for 1981, 1982, and beyond. Many of the choices for both program expansions and cutbacks that are now available for later years will either not be available at

this time next year or at best will be severely circumscribed. Reductions in the President's budget and other cuts proposed by the Congress will, if enacted in 1980, have significant effects on the 1981-1984 budgets, but small outlay effects in 1980. A multiyear framework for considering the first concurrent resolution will insure that the committee has the opportunity to consider the 1980 budget in the light of long-term goals for the economy and the federal budget.

