STATEMENT OF

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before the

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Mr. Chairman, I am pleased to appear before this Committee as you prepare to consider appropriation requests for fiscal year 1982 and proposed supplementals and rescissions for the current fiscal year.

As the Congress reexamines the 1981 budget and begins work on 1982, the serious difficulties of the current economic and budgetary situation are apparent.

- <u>Federal spending has grown rapidly in the last several years.</u> Unified budget outlays grew by 17.4 percent in 1980, and they are expected to grow by over 14 percent in 1981. Total outlays would grow by another 12 percent in 1982 under President Carter's spending proposals. Outlays as a percentage of GNP are projected at 23 percent for 1982 in the Carter budget, a full 2 percentage points higher than the goal set by President Carter when he took office.

- <u>Budget deficits have persisted in good years and bad.</u> The federal budget has not been in balance since 1969. During the last six years, the cumulative budget deficit has been $306 billion. If spending by the Federal Financing Bank (FFB) and other off-budget entities is included, the total budget deficit since 1975 has been $368 billion. The 1981 budget is now projected to have a deficit of at least \$55 billion--\$78 billion if off-budget outlays are included. As a result of these deficits, as well as a further deficit in 1982, the federal debt is projected to exceed \$1 trillion during the next fiscal year.

- Half of the growth in outlays since 1975 has been in Social Security and other payments for people. Most of these payments are mandatory entitlements under current law, and are indexed directly or indirectly for inflation. They now constitute almost 50 percent of the budget. CBO projects that these payments will grow by \$240 billion over the next five years under current law, as the retired population expands and adjustments are made for increases in the cost of living.

- Increased benefit payments coupled with desired and built-in spending, will make it extremely difficult to slow spending growth. CBO's preliminary projections of federal outlays over the next five years suggest that spending growth will average at least 10.5 percent a year under current policies. Both the Congress and the new Reagan Administration have expressed a strong commitment to expand the rate of defense spending, which under current policy is already projected to increase by an average of over 12 percent annually. The growth in benefit payments for individuals is projected to average 11.5 percent. Reductions in entitlement benefits and other nondefense spending programs have proved very difficult to achieve in the past.

- The current outlook for a sluggish economy and continued high inflation means that only drastic action by the Congress can reduce spending growth and budget deficits. Most economists expect slow economic growth during the next year, and some project a renewed recession in the first part of 1981. This would have the effect of maintaining relatively high levels of spending for unemployment compensation and reducing federal revenues. Inflation is expected to come down only slowly; thus, spending for indexed benefit programs will continue to grow at a healthy clip. The longer-term outlook for the economy is very uncertain; an escalation of inflation because of large oil price increases, another year of bad crops, or more severe unemployment could worsen the budgetary outlook.

This is a grim outlook for the budget. It presents a serious dilemma for the Congress in pursuing the goals of sustained tax cuts, real growth in defense spending, and a balanced budget within the next few years. Achieving these goals will require sizable cuts in nondefense spending programs.

In past years Appropriations Committees consistently have been able to reduce the President's requests for annual appropriations. But the growth in indexed benefits and other mandatory spending has allowed an increasing share of the federal budget to escape the annual competition with other programs for federal dollars.

During the past 10 years, the relative control over federal outlays that can be exerted through the annual appropriations process has fallen sharply. In fiscal year 1970, the Appropriations Committees could exert control on 59 percent of federal outlays. By 1980, this control had fallen to 41 percent, of which about half was for defense spending. If the growth of federal spending is to be reduced in the future, it is clear that committees of the Congress that have jurisdiction over entitlements and other mandated spending will have to play a greater role in achieving budgetary savings.

In the remainder of my statement, I will discuss in more detail the budget and economic outlook for both the current fiscal year and 1982.

THE CHANGING OUTLOOK FOR THE 1981 BUDGET

Less than one year ago, the Congress planned to balance the budget in fiscal year 1981. The latest estimates from the Carter Administration suggest that the 1981 budget could have a deficit of over $55 billion, almost the same size as the 1980 deficit. Most of the deficit can be attributed to higher spending than was contemplated by the first resolution, not to lower revenues. As shown in Table 1, the first resolution set an outlay target of $613.3 billion. President Carter's 1982 budget submitted 12 days ago estimates 1981 outlays at $662.7 billion, almost $50 billion higher.

TABLE 1. FEDERAL BUDGET TOTALS FOR FISCAL YEAR 1981 (In billions of dollars)

	First Budget Resolution	Second Budget Resolution	President Carter's Budget
Revenues	613.8	605.0	607.5
Outlays	613.3	632.4	662.7
Surplus or Deficit (-)	0.5	-27.4	-55.2
Budget Authority	697.2	694.6	726.5
Debt Subject to Limit	934.4	978.6	987.3

Most of the increase in 1981 spending estimates resulted from events over which the Congress has little or no control under current laws. While the first resolution was being debated, the economy declined more than expected as a result of tight monetary policy and credit controls. During the April-June quarter, the economy declined in real terms at a 9.9 percent annual rate, the sharpest single-quarter contraction of the post-World War II period. This pushed up unemployment to higher levels than expected, and triggered extended unemployment insurance benefits. The automobile industry was particularly hard hit, and trade adjustment benefits were provided to unemployed auto workers. As a result, unemployment benefit costs rose sharply in 1980, and are projected to remain at fairly high levels in 1981. This accounts for over $7 billion of the increase in estimated spending from the first resolution.

Higher interest rates during the last several months account for an even larger part of the increase in 1981 estimated outlays. Net interest costs are now projected to be over $8 billion higher than assumed for the first resolution. The increase in interest rates also means that the cost of student loan insurance will be higher, that fewer federal loan assets will be sold to the public, and that federal assistance to failing thrift institutions will be more than expected a year ago. This adds another $3 billion to the 1981 outlay estimates .

Spending for various indexed benefit payments and other transfer programs that are affected by inflation and high unemployment is now projected to be almost $8 billion higher than estimated for the first budget resolution. The largest increases are for federal employee retirement benefits and health care services, partly as a result of the failure of the 96th Congress to achieve the cost savings contemplated for these programs in the first resolution.

Defense spending is also up about $7 billion from the level assumed for the first budget resolution. Part of this increase results from a larger October 1980 pay raise for both military and civilian employees than was assumed for the resolution. Most of the increase, however, is the result of higher spending rates for procurement of weapon systems, together with stepped-up defense activities and fuel costs.

Unexpected events also cause increases in federal spending. For example, disaster assistance and Corps of Engineers spending will be about $2 billion higher in 1981 than expected because of Mt. Saint Helens and other natural disasters last year. The heavy influx of Cuban/Haitian entrants last year will also cause 1981 spending for refugee assistance to be higher than expected a year ago. The recent Penn Central settlement will add another $2.1 billion to federal spending in 1981.

On the revenue side, expected receipts have fallen off slightly because of lower incomes than were assumed for the first budget resolution. Current law revenues for 1981 are now projected to be about $605 billion. President Carter's 1982 budget proposes a net tax increase of $2.5 billion in 1981, largely as a result of his proposal for a 10 cents-per-gallon increase in the federal gasoline tax. The second budget resolution approved in November, however, assumed a 1981 tax cut that would reduce fiscal year 1981 receipts by $10 billion. If such a tax cut were passed, with little or no reductions in spending and no other tax changes, the 1981 budget deficit could approach $70 billion. Some spending reductions can still be made in 1981, but time is rapidly running out to achieve savings of any great magnitude.

THE ECONOMIC OUTLOOK

The Carter Administration's budget estimates for fiscal year 1982 are based on a forecast of weak economic growth for a recovery period with very modest improvement in inflation. This view of the economic outlook is generally in line with the consensus forecast of business economists (see Table 2). Nevertheless, the economic outlook is very uncertain.

An acceleration of inflation and record interest rates in the last quarter of 1980 have caused most forecasters to predict a sharp slowdown, if not a decline, in economic growth together with rising unemployment during the first half of 1981. Some economists expect that the economy will bounce back vigorously after midyear, partly because of the enactment of tax cuts. Others believe that economic growth will be very weak during the next few years, given the momentum of inflation and the expectation that the Federal Reserve will pursue stringent monetary policies until the rate of inflation shows a substantial improvement.

Inflation generally is expected to remain at double-digit levels in 1981, with some moderation during 1982. The unemployment rate is generally projected to drift higher in the first half of 1981 and then decline slowly for the next 18 months. Interest rates are expected to be volatile but to remain at relatively high average levels throughout the forecast period.

TABLE 2. THE CARTER ADMINISTRATION'S ECONOMIC FORECAST, CBO'S PRELIMINARY PROJECTIONS, AND THE FORECAST RANGE OF FOUR COMMERCIAL FORECASTERS, 1981-1982

	Carter Administration Forecast a/	CBO Preliminary Projections b/	Range for Commercial Forecasts c/
Nominal GNP (Percent change)			
1980:4 to 1981:4	12.3	12.8	11.3 to 12.6
1981:4 to 1982:4	12.6	14.1	12.1 to 15.4
Real GNP (percent change)			
1980:4 to 1981:4	1.7	2.2	1.0 to 3.2
1981:4 to 1982:4	3.5	4.0	3.7 to 5.8
Inflation (percent change in GNP deflator)			
1980:4 to 1981:4	10.4	10.3	9.1 to 10.2
1981:4 to 1982:4	8.8	9.7	8.0 to 10.2
Consumer Price Index (percent change)			
1980:4 to 1981:4	12.6	10.0	10.9 to 12.4
1981:4 to 1982:4	9.6	9.7	8.8 to 10.4
Unemployment Rate (percent)			
1981:4	7.7	7.9	7.1 to 8.2
1982:4	7.4	7.1	6.1 to 7.7

NOTE: The forecasts are not directly comparable because of differences in economic and policy assumptions and differences in forecast dates.

a/ Budget of the United States Government Fiscal Year 1982, p. 3.

b/ CBO's preliminary projections, prepared in late November, for analyzing the Carter Administration's budget. CBO is currently working on its forecast for 1981-1982.

c/ The models and dates of forecasts are:

Chase Econometrics, Inc., January 7, 1981
Data Resources, Inc., December 24, 1980
Evans Economics, January 7, 1981
Wharton Economic Forecasting Associates, Inc., December 3, 1980

Comparisons of the Carter Administration's forecast with other economic forecasts should, however, be interpreted with caution. Different fiscal policy assumptions underlie the various forecasts. In particular, all of the commercial forecasts assume some cuts in individual income taxes in 1981, and none assume an increase in the gasoline tax or withholding of taxes on interest and dividends, which are incorporated in the Carter Administration forecast. Three of the four commercial forecasts expect economic growth to be from 1.0 to 1.8 percent in 1981. That is close to the Carter Administration's estimate, but these forecasts would likely be below the Carter Administration's if they used the same assumptions for tax policy.

THE 1982 BUDGET OUTLOOK

The budget outlook for 1982 is little better than that for the current year. The growth in revenues under current law is expected to accelerate to 17.2 percent in 1982, for an increase of $104 billion, as a result of legislated increases in Social Security taxes, continued high inflation that pushes people into higher tax brackets, real economic growth, and increases in corporate and other taxes. CBO's preliminary projections for 1982 outlays under current policies show a falling off in spending growth to about 12.5 percent. The projected deficit under these assumptions declines to about $34 billion, as shown in Table 3.

The budget presented by President Carter stresses increased spending for national defense; tax cuts and spending increases to encourage capital formation and increased industrial productivity; and various measures, including a 10-cents-a-gallon increase in motor fuel taxes, to encourage energy conservation. To help offset the rise in Social Security taxes, the Carter budget proposes that individuals and employers be given an 8 percent income tax credit. Various budget reductions and proposed legislative savings would offset most of the recommended spending increases above current policy levels.

TABLE 3. FEDERAL BUDGET TOTALS FOR FISCAL YEAR 1982 (In billions of dollars)

	CBO Baseline Projections	President Carter's 1982 Budget	CBO Reestimate of Carter Budget
Revenues	708.5	711.8	711.8
Outlays	742.9	739.3	745.0
Deficit (-)	-34.4	-27.5	-33.2

The net effect of the Carter budget proposals would be a small increase in both revenues and outlays above CBO's baseline projections. CBO's analysis of President Carter's budgetary proposals, which was prepared at the request of the House Appropriations Committee and is being released today, suggests that they would result in a $33.2 billion budget deficit in 1982, compared to the $27.5 deficit estimated by the Carter Administration.

All of these budget estimates are based on relatively optimistic assumptions about the economy during the next two years. As I mentioned earlier, there is a great deal of uncertainty about how the economy will perform over this period. Two of the most important sources of uncertainty are inflation and monetary policy. Another sizable boost in oil prices above those assumed in the forecasts, or a year of bad crops, would substantially alter the outlook for the worse. With respect to monetary policy, the Federal Reserve faces the very difficult challenge of reducing inflation. Many believe that its policies are likely to choke off or delay the projected economic recovery.

Most of the risks for the budget seem to be on the pessimistic side; that is, if economic growth is slower than forecast, revenues could be much lower than currently projected and outlays higher. The size of the budget deficit will also depend to a large extent upon how large a tax cut is enacted and how much the built-in growth in federal spending can be reduced.

About half of the projected $83 billion increase in estimated outlays in CBO's baseline projections for 1982 can be attributed to cost-of-living adjustments and to the growth in recipients of various benefit payment programs that are directly or indirectly indexed for inflation. These account for $40 billion, or 48 percent of the projected increase in total outlays between 1981 and 1982 under current policies. Defense spending, other than for retired pay and projected pay raises, is estimated to increase by $10 billion in 1982 as a result of decisions made by the 96th Congress. Net interest costs are also projected to rise about $10 billion in 1982. The remaining increase is almost entirely accounted for by discretionary inflation adjustments for defense and other federal programs, and by projected pay raises for federal civilian and military employees. These adjustments would add an estimated $21 billion to outlays in 1982.

Given these built-in increases, and the pressures for increased defense spending, it will be very difficult to reduce 1982 outlays much lower than $740 billion. This does not mean that I consider such reduction an impossible task. On the contrary, I believe that considerable reductions can be made in federal spending, but that it will take a massive effort on the part of all the committees in the Congress. It is not a task that can be done by the Appropriations Committees alone, for the reasons I made clear in my introductory remarks. The CBO will shortly present a report to the Budget Committees that discusses a large number of possible actions the Congress can take to reduce the growth in federal spending.

Unless significant cuts are made in outlays in 1982, the budget deficit could easily exceed $70 billion if taxes are cut by $40 billion or more as contemplated in the second budget resolution. If the economy performs more poorly than forecast, because of poor crops or higher than projected oil price increases or a more restrictive monetary policy, the 1982 deficit could be even higher.