Statement of Alice M. Rivlin
Director, Congressional Budget Office
before
Committee on Armed Services
United States House of Representatives
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Mr. Chairman and Members of the Committee:

I am pleased to have this opportunity to appear before you today as you work on the fiscal year 1977 budget. I think it would be most useful if I confine my remarks today to two areas:

- o CBO's projections of the "current policy" defense budget; and
- o Evidence on the relationships between defense expenditures, employment, and national income.

I. Projections of the Defense Budget

In order to evaluate competing budget options, it is essential to have a reference point with which alternatives can be compared. Only with such a baseline can proposed shifts in spending priorities and taxing policies or suggested changes in the overall size of government be clearly seen. In the past, the estimates for the current fiscal year, published in the President's budget, have usually served as the baseline against which the President's proposals for the new budget year are compared. Budget options suggested by others generally have been contrasted with the President's proposals for the coming fiscal year.

These practices have not worked well for several reasons. First they are often confusing. The current fiscal year estimates reported in the President's budget often

contain policy changes that do not conform with enacted legislation or with the probable outcome of pending Congressional actions. They usually reflect proposed rescissions and deferrals, proposed legislative initiatives, and accounting changes, all of which obscure the real year-to-year differences.

Second, the comparison of the Administration's budget year request with the current year levels gives little insight either into the discretionary changes that are being proposed or the changes that are being suggested in the real levels of various government programs. For example, a large increase in outlays in the income security function may represent no more than a continuation of existing programs whose spending levels are being forced up automatically by the entitlement nature of these programs. Similarly, what may seem to be a significant increase in the budget authority requested for a particular grant-in-aid program may, in fact, turn out to represent less than the amount needed to provide recipient state and local governments with grants of unchanged purchasing power.

The Congressional Budget and Impoundment Control Act of 1974 requires the CBO to produce five-year budget projections. The CBO on January 26 issued its first Five-Year Budget Projections report. The CBO projections provide a base to which

budget proposals, including the President's proposals, could be compared. These projections represent the estimated cost of continuing on-going federal programs and activities at 1976 levels. The latest statement of Congressional policy, namely, the Second Concurrent Resolution on the Budget--Fiscal Year 1976, is taken as the 1976 overall, aggregate level.

The outlays required to sustain government programs at current levels and the receipts collected under current tax laws depend, of course, on overall economic conditions. Because of the uncertainty surrounding the economic outlook, particularly in the long run, the projections were made under two sets of economic assumptions. The first, path A, assumed a strong recovery from the current recession with the unemployment rate falling to 4.5 percent in 1980 and 1981. Under the second, path B, recovery would not be quite as strong, but it would still be close to the most rapid five-year economic growth rate actually experienced since World War II.

How the Current Policy Budget Projections Were Made

The basic assumption underlying CBO's projection of federal receipts is a simple one: present tax laws are assumed to continue in force.

The assumptions for spending are more complicated:

--Federal programs are assumed to be continued or renewed except in cases where they are clearly of a one-time nature. Thus, for example, it is assumed that DoD employment of civilian and military personnel remains constant and that their salaries are raised as provided by law. An example of a one-time program is the special appropriation of $1.4 billion for cost growth and escalation in the fiscal years 1970-75 shipbuilding programs. This was not included in the base for the fiscal years 1977-81 projections. However, the additional $1 billion that the committee report indicated would be needed was added to the fiscal years 1977 and 1978 procurement projections, with $.7 billion in 1977 and $.3 billion in 1978.

--Budget authority for procurement programs and for operations and maintenance was projected at 1976 levels, adjusting for assumed inflation.

--Programs involving entitlements were generally projected by estimating expected changes in the covered population and adjusting for assumed price changes. For example, military retired pay projections allowed for expected growth in the pool of retirees and the fact that new retirees will enter retirement with a higher

wage history than those who retired earlier. The projections also allowed for assumed changes in the Consumer Price Index.

In general, except for the retired pay, projected growth in defense budget authority in the Current Policy Budget (CPB) projection is due simply to inflation.

CBO's Current Policy Budget Projections

Table 1 shows the CPB projections of the National Defense budget together with the projections presented in the President's budget document for fiscal 1977. CBO's path B economic assumptions correspond very roughly to the President's assumptions, so comparisons between these two projections are reasonably meaningful.

The principal difference between CBO's and the President's projections is that CBO projects higher pay increases and lower purchases increases; the President imposes pay caps in fiscal year 1977 and pay increases based on the Rockefeller Commission's proposals for the later years and an average of 4 percent real growth in purchases over this period. In budget authority, the President's budget for 1977 is nearly $5 billion above the CPB level. By 1981, the difference between the two grows to $12 billion. This gap is a partial measure of the extent to which the 1977 and later budgets are supposed to reverse the decline in the real value of defense expenditures.

TABLE I

Projected National Defense Budget Authority and Outlays
(Fiscal Years, in billions of current dollars)

	CBO Current Policy Budget Projections				The President's Budget Projections	
	Path A*		Path B**			
	B/A	Outlays	B/A	Outlays	B/A	Outlays
1976 (est.)	$101.0	$ 91.9	$101.0	$ 91.9	- - -	- - -
Transition Quarter (est.)	24.0	24.8	24.0	24.8	- - -	- - -
1977	111.4	103.4	110.0	103.4	$114.9	$101.1
1978	119.3	115.0	118.3	114.5	122.4	112.9
1979	127.5	119.6	125.3	118.0	131.9	121.5
1980	136.9	130.8	132.3	127.2	141.6	132.4
1981	146.5	141.3	139.5	135.6	151.5	142.8

* 6 Percent Average Real GNP Growth
**5 Percent Average Real GNP Growth

In outlays, the relationship between the President's projections and the CPB is more complex. By proposing a number of savings -- particularly by limiting the size of salary increases -- the President's budget reduces fiscal 1977 and 1978 outlays below CPB levels. As these constraints on pay are lifted and as the increased budget authority for procurement begins to be spent out, the President's projected outlays grow beyond the CPB projected outlays after fiscal 1978.

In discussing the President's program, it is most important to bear in mind the fact that it holds down near-term outlays in part by changing policy on pay rather than simply by using fewer employees or other real resources. The effect of the limitations on pay is shown in Table 2. This presents an estimate of what the National Defense CPB would be, assuming:

- o a 4.5 percent military pay raise;
- o a 4.7 percent classified employees pay raise;
- o a 3.4 percent wage board pay raise;
- o elimination of the "kicker";
- o CBO path B economic growth and inflation rates.

These correspond approximately to the President's budget assumptions. Under these assumptions, CPB outlays for fiscal

TABLE 2

Five Year National Defense Projections
Using President's Assumptions on Military and Civilian Pay
(Fiscal years, in billions of current dollars)

	CBO Projection, Path B Assumption on purchase inflation and retirement, President's Assumption on Pay		President's Budget Projections	
	B/A	Outlays	B/A	Outlays
1977	$107.6	$100.1	$114.9	$101.1
1978	114.5	110.8	122.4	112.9
1979	120.6	113.3	131.9	121.5
1980	127.1	122.0	141.6	132.4
1981	133.3	129.4	151.5	142.8

1977 would lie $1.1 billion below the President's budget. In budget authority, the difference of $7.3 billion corresponds approximately to the estimate of Secretary of Defense Rumsfeld that there is about $7 billion of real growth in this year's budget request.

The Current Policy Budget and "Real" Expenditures

In the last two years, the rate of "real" growth or decline in defense spending has figured in debate over the federal budget. If we adjust for price changes in the generally accepted way, inflation has approximately offset the growth in the "nominal" or current dollar defense budget over the last 20 years. Table 3 shows the estimated constant dollar budget since 1955.

How should we interpret these "constant dollar" measures of defense expenditures? The analogy between the price index for defense and the Consumer Price Index (CPI) is quite imperfect. CPI measures changes in the cost of buying a constant bundle of commodities in particular locations over time. Bureau of Labor Statistics fieldworkers sample the prices of well-specified products in the same stores month after month. New products are introduced into the index occasionally and products that become rare are eventually dropped, but changes are relatively infrequent. Occasionally the index is

TABLE 3

National Defense Budget Authority,
Outlays, and TOA
Fiscal Years 1955-1977

(In millions of Fiscal Year 1977 dollars)

	B/A	Outlays	TOA*
1955	$ 96,868	$113,275	$104,059
1956	98,000	108,843	110,467
1957	106,344	110,729	111,934
1958	104,610	109,589	110,089
1959	111,299	110,508	108,493
1960	108,642	108,191	102,427
1961	108,351	108,856	110,911
1962	122,866	117,644	119,527
1963	124,974	118,778	119,664
1964	119,667	118,166	115,431
1965	114,874	107,011	112,596
1966	140,134	118,580	140,262
1967	152,651	141,179	149,014
1968	155,038	155,865	150,246
1969	149,185	150,918	147,997
1970	132,061	138,099	132,511
1971	121,362	124,903	121,194
1972	119,317	117,070	116,465
1973	114,177	106,629	111,567
1974	112,962	101,704	107,321
1975	105,352	99,710	100,695
1976	109,703	99,874	105,317
Transition Quarter	24,084	25,982	23,734
1977	114,905	101,129	112,709

* Total Obligational Authority includes DOD and Military Assistance Programs.

adjusted on the basis of consumer expenditure surveys to reflect the fact that the composition of consumers' expenditures changes. These changes in the "market basket" introduce some ambiguity into the interpretation of the CPI, but on the whole the problems are small.

In the case of expenditures on defense, the problems of price measurement are much more difficult. The defense "market basket" is composed of a large number of heterogeneous products; the character of the products changes fairly rapidly over time; competitive market prices for many of the commodities are unknown; and the balance of various commodities in the package can change rapidly. All of these characteristics make measurement of price changes in defense expenditures more difficult.

The index used by DoD and the Department of Commerce to deflate defense purchases is a measure of the prices of all federal purchases. Some of the commodities in the "market basket" are purchased by DoD. Others are not. So the index is only an approximate measure of the prices DoD pays. It is probably an adequate measure for the rough determination of major trends, but certainly not for precise judgments.

Even if prices were measured perfectly, it would still be important to realize what these constant dollar comparisons

can tell us. If constant dollar expenditures on defense remain the same, it does not mean that we are in any real sense purchasing the same amount of "security" as we purchased in the past. We have to take account of the threat against which we prepare, the likely behavior of our adversaries and allies, and productivity changes that might be occurring in the defense sector.

As a result of all this, constant dollar comparisons may give us an adequate measure of approximately what we have to give up in private or other public sector output to buy the particular bundle of defense-related commodities that we have decided to purchase, but they do not give us too much more.

CBO's Current Policy Budget projections hold approximately constant, in real terms, the resources devoted to operating, maintaining, and modernizing U. S. forces. They are independent of any increase or decrease in external threats to our national security and do not necessarily imply a constant defense capability or constant deterrence levels. The dollar value of the resources required for a constant defense capability may, in fact, be different from those projected here, where the levels approved for 1976 are held constant in real terms over 1977-81.

Similarly, there is no detailed force structure or defense program behind the CBO current policy projections. They hold real expenditures and manpower approximately constant; they need not -- and in fact probably would not -- support exactly the current forces over the long run.

As Chart 1 shows, however, the CPB projections do hold the percentage of federal outlays going to National Defense approximately constant from fiscal year 1976 to fiscal year 1981.

II. The Defense Budget in the Economy

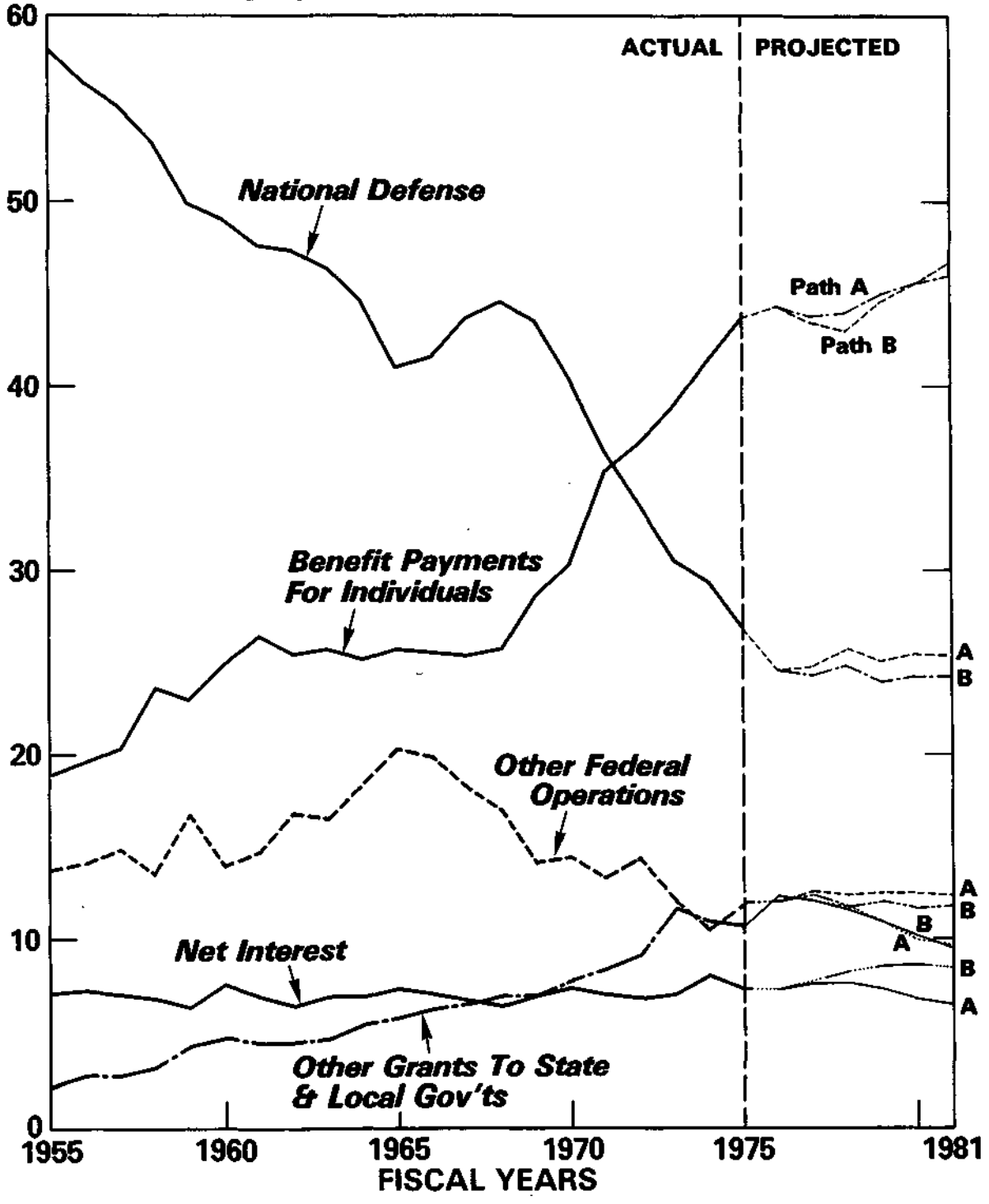
It seems highly likely that both inflation and unemployment will remain at unsatisfactory levels through 1977 and perhaps into 1978. Depending on fiscal and monetary policy choices as well as a number of other uncertain possibilities, inflation or substantial unemployment, or both, could persist even longer. This year's federal budget -- and this year's defense budget -- must be viewed against that economic background.

The prospect of continued unemployment raises questions about the role of defense expenditures in generating jobs and income.

This committee heard testimony in December from representatives of DoD and the Public Interest Research Group in

CHART 1.

COMPOSITION OF FEDERAL SPENDING



Michigan (PIRGIM) on the effect of defense expenditures on employment. Chairman Price asked me to comment on this issue and on the evidence offered.

In my view, the PIRGIM analysis is not particularly helpful. The work is based on estimates by Professor Bruce Russett showing on average the relation between the proportion of the GNP spent on defense and the proportion spent on consumption, or investment, or imports, and the like. Since the parts of the GNP have to add to the whole, it is not surprising that, on average, a higher proportion of defense spending is associated with a lower proportion of spending of other kinds. Professor Russett acknowledges that the relations are somewhat ambiguous. Since they are based on the 1939-1968 period, the relations are affected, for example, by rationing and controls on investment during World War II.

Furthermore, if World War II is omitted from the data and the years after 1968 are added, the explanatory power of the relationships declines sharply. In addition, there are a number of more technical econometric problems with the estimation of the equations and his methods.

Even if Russett's estimates were impeccable and even if they applied to current data, they were not designed to

support the analysis for which PIRGIM used them. Professor Russett has indicated this in a letter to Chairman Price.

Other data have been presented to you by DoD measuring defense-related employment in industry. The conclusion generally drawn from these is that defense spending is not greatly different in its average effect on employment from other spending. Even these data are arguable, although they probably are good enough to support the conclusion.

As you probably realize, it is hard to categorize firms or industries as "defense-related" or "non-defense-related." Many firms that sell to DoD sell also to other buyers. The proportion of sales to DoD is also likely to change over time. Such problems make the Bureau of Labor Statistics' series on employment in defense-related industry only imperfectly related to the size of the DoD program.

There are two other possible approaches to estimating the employment effects of defense expenditures. First, the standard econometric forecasting models can be used to produce estimates of the change in nominal GNP or employment following an increase in defense outlays. CBO has done this with three such models. The estimates differ among the models, but they do not refute the hypothesis that defense

and non-defense expenditures, on average, have broadly similar effects. The evidence of the models is so uncertain and weak in part because they were not designed primarily to answer this kind of question.

A second approach might look in great detail at the composition of particular defense purchases, and at the regions and industries affected. Such work would probably show that it is hard to generalize confidently about the effects of defense expenditures on employment.

Defense-created Employment and the Unemployment Rate

Much of the concern with the overall employment effect of defense outlays is misplaced. Is defense spending more or less stimulative than other kinds of federal government expenditures? It is important to observe that the answer to this question provides little guidance to the selection of a defense budget. While individual decisions within the DoD budget can have extensive effects on the economic stability of some localities and states, the nationwide effects of total defense spending on employment are not more stimulative than other types of federal spending. There are many combinations of tax policy, monetary policy, expenditure policy, and other tools at the command of the

government that can move the economy to the same level of employment. Even if it were true that defense expenditure is less expansionary than expenditures on health or other activities, then it would still be possible within the same total budget to change taxes or to adjust monetary policy to hit the same employment target with high or low defense expenditures. This flexibility means the Congress can decide on expenditures for health or defense or for other programs on the basis of perceptions of their priority rather than on the basis of their contribution to total employment.

In addition, defense spending is an awkward countercyclical tool. Although it is true that defense outlays appear to have much the same effect on income and employment as other kinds of outlays, it is not outlays that the Congress votes but budget authority. In defense, voting of budget authority may imply long-term commitments and acceptance of long-term constraints. Authorized procurement may not generate increased outlays for several years. Authorization of increased manpower will raise force levels for some time. Stimulus may arrive inappropriately late or persist too long.

Thus, decisions to spend somewhat more or somewhat less on defense are hard to link to total federal economic policy. The Congress may prefer to make such decisions on the merits of the proposed expenditures themselves rather than on the basis of arguments about employment, inflation, and national product.