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before the
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Mr. Chairman, my testimony today covers four subjects: the economic outlook, as projected by CBO with budget policies now in force; the economic impact of the Administration's proposed budget; the impact of other fiscal policy options included in the CBO economic report released today; and the long-run budget outlook.

THE OUTLOOK UNDER CURRENT POLICY

If Congress were to adopt a fiscal year 1979 budget that simply continued current tax and expenditure policies, there is a danger the economy would slip into a growth recession--that is, growth is likely to slow to a pace that would halt the further decline in unemployment.

CBO's "current policy" forecast (shown in Table 1) projects a moderate growth in real GNP of 3.5 to 4.5 percent between the end of 1977 and the end of 1978 and an even lower rate of 2.4 to 3.9 percent during 1979. Both rates fall markedly below the 5.7 percent rate at which the economy grew during 1977.

Reduced growth in 1979 would mean little progress in reducing unemployment. CBO estimates that, in the absence of policy change, the unemployment rate would decline only slightly from its current level to between 6.0 and 6.5 percent by the end of 1978, and would change little or even edge back up in 1979.

TABLE 1. CBO'S ECONOMIC FORECASTS BASED ON CURRENT POLICY: CALENDAR YEARS 1978-1979

Economic Variable	Level			Rates of Change (percent)		
	1977:4 (actual)	1978:4	1979:4	1976:4 to 1977:4 (actual)	1977:4 to 1978:4	1978:4 to 1979:4
GNP (billions of dollars)	1,965	2,150 to 2,190	2,230 to 2,430	11.9	9.4 to 11.5	8.2 to 10.9
GNP (billions of 1972 dollars)	1,361	1,410 to 1,420	1,440 to 1,480	5.7	3.5 to 4.5	2.4 to 3.9
General Price Index (GNP deflator, 1972=100)	144	152 to 154	161 to 164	5.9	5.7 to 6.7	5.7 to 6.7
Unemployment Rate (percent)	6.6	6.0 to 6.5	6.1 to 6.6	--	--	--

At the same time, CBO sees little prospect for a reduction in inflationary pressures, even in the face of reduced economic growth during the next two years. Inflation rates are expected to be in the 5.7 to 6.7 percent range in both 1978 and 1979--about the same as the increase in nonfood prices during 1977.

That forecast assumes continuation of the tax and expenditure policies already legislated or included in the second concurrent resolution. The CBO forecast thus includes the effect of recent tax changes in social security and unemployment insurance, but excludes the energy legislation now in conference and the Administration's recently announced fiscal stimulus package. With allowances made for expected shortfall, federal outlays on a unified budget basis were assumed to be $455 billion in fiscal year 1978 ($3 billion below the targets contained in the second concurrent resolution) and $494 billion in fiscal year 1979.

A major reason for expecting slower economic growth in the future is that the federal budget will itself exert a restrictive effect on the economy, if current policies remain unchanged. One useful measure of the budget's impact on the economy is the change in the high-employment budget--the receipts and outlays that would occur if the economy were

operating at high employment (defined as 4.9 percent unemployment). CBO estimates that on a high-employment basis the current policy budget (NIA basis) would move from an $18 billion high-employment deficit in fiscal year 1978 to a $3 billion high-employment surplus in fiscal year 1979. That $21 billion swing in a restrictive direction is primarily attributable to:

- o reduced spending growth, under current policy,
- o legislated increases in social insurance taxes, which take effect in January 1979, and
- o increases in effective personal income tax rates, due to the interaction of continued high rates of inflation and the progressive tax structure.

In addition to the current policy federal budget, with its increased fiscal drag, other factors are also expected to contribute to slower economic growth by late 1978. Single-family housing starts rose to record levels during the current expansion; they are expected to remain strong in the near term but to recede significantly later in 1978 as a result of higher interest rates and reduced savings flows. Consumer spending during this recovery has also been boosted by the willingness of households to reduce their saving rates. Most economic forecasters believe that the decline in the saving rate has

ended; this would also slow growth in aggregate demand. Recent surveys of business spending plans likewise indicate a planned deceleration in capital goods outlays in 1978.

The current economic expansion began in the spring of 1975, almost three years ago. It is not unusual for economic growth to slow this late in a business cycle expansion. In fact, an uninterrupted continuation of economic growth to the end of 1979 would make the current expansion the longest peacetime expansion in the United States in over a century.

Monetary Policy Assumptions

The accuracy of the current policy forecast hinges in part on whether CBO's assumptions regarding monetary policy and the consequent projections of credit market conditions are reasonably accurate. Short-term interest rates are projected to continue to rise from their levels at the end of 1977, but that rise is expected to be moderate enough to avert stringent credit conditions involving a widespread movement of funds from thrift accounts into short-term market instruments with higher yields. If rates should move substantially higher, the current policy forecast for 1978 would be much less favorable, due to the adverse impact on residential construction and business investment spending.

CBO's assumption of only moderate additional interest rate increases is estimated, given current fiscal policy, to be roughly consistent with growth in the broadly defined money supply (M2) at around 9 percent a year--the upper end of the Federal Reserve Board's announced target range for this monetary aggregate.

Room For Expansion and the Threat of Inflation

Inflationary pressures remain very strong. At the moment, however, and for the projected period, inflationary pressures do not appear to arise from excessive demand. The economy still has a significant amount of unused resources, both labor and capital. The unemployment rate has declined substantially during this expansion, reaching 6.3 percent in January 1978. But that rate still remains well above the 5.0 to 5.5 percent range generally thought to indicate tight labor markets given the current composition of the labor force. Measures of physical capacity in manufacturing likewise suggest that plant and equipment are still not fully utilized. Thus, the economy still seems capable of achieving economic growth somewhat in excess of the long-term potential growth rate (estimated at about 3.5 percent per year) without generating substantial added inflationary pressures, induced by an overheated economy.

FORECASTS WITH ALTERNATIVE FISCAL POLICIES

Mr. Chairman, I would now like to discuss the economic outlook with alternative budget assumptions, beginning with the Administration's budget, then proceeding with two of the options contained in our economic report. For comparative purposes, CBO's current policy forecast will serve as a baseline. That should help the Committee consider the type and degree of budgetary changes that are needed to move toward your goals for the economy.

The Administration's Stimulus Proposal

One alternative to current policy that would lead to a greater rate of growth is the Administration's proposal for tax reductions and increased outlays.

The tax cuts proposed by the Administration would reduce taxes in fiscal year 1979 by approximately $25 billion below current policy levels (as estimated by CBO), and they would reduce taxes in fiscal year 1983 by nearly $35 billion. Excluding energy rebates, the net tax cut for individuals in 1979 would be $18.3 billion ($22.5 billion in tax reductions, offset by $4.2 billion in reforms); the net tax cut for corporations would be $5.1 billion ($6.3 billion in reductions, offset by $1.1 billion in reforms). In addition, telephone

excise and unemployment insurance taxes would be reduced by $1.6 billion. Those cuts would be partly offset by the $1.1 billion in additional revenues in fiscal year 1979 as a result of the net impact of the energy tax measures included in the Administration's budget.

In terms of outlays, the budget proposed by the President represents essentially a continuation of current policy with few new spending initiatives. Under the budget, outlays would increase by approximately $6 billion in fiscal year 1979, compared with CBO's estimated current policy levels. The principal increases in expenditures would be in the areas of education, training, employment, and energy; some offsetting decreases are also proposed.

<u>Fiscal Impact of the Administration Proposals</u>. CBO estimates that the Administration's proposals, if enacted, would increase real rates of growth for calendar year 1979 about 1 percentage point from the current policy range of 2.6 to 4.0 percent (see Table 2). A reduction in the unemployment rate of perhaps 0.3 percentage points in 1979 is forecast if the Administration's package is accepted. The number of people employed would increase by about half a million

TABLE 2. COMPARISON OF ADMINISTRATION AND CBO ECONOMIC FORECASTS: BY CALENDAR YEARS a/

	CBO Current Policy Forecast	CBO Forecast With Administration Fiscal Policy Proposals	Administration Forecast of Its Policy
Economic Growth (percent change in constant dollar GNP)			
1977 to 1978	4.0 to 5.0	3.9 to 4.5	4.7
1978 to 1979	2.6 to 4.0	3.5 to 4.9	4.8
Inflation (percent change in the implicit price deflator)			
1977 to 1978	5.6 to 6.6	5.9 to 6.9	6.1
1978 to 1979	5.7 to 6.7	6.3 to 7.3	6.2
Unemployment Rate (percent)			
1978:4	6.0 to 6.5	6.0 to 6.6	6.2
1979:4	6.1 to 6.6	5.7 to 6.3	5.8

a/ The GNP estimates in this table are on a calendar year basis. Therefore, the current policy estimates are not directly comparable with those in Table 1 which are on a fourth-quarter calendar year basis. Calendar year estimates were used here so that the Administration's forecast--which is only published on a calendar year basis--could be included for comparison.

by year-end. Although the rate of inflation would probably not be significantly affected by the stimulus measures during 1979, the energy program would have an immediate impact on inflationary pressure. By the end of 1979, CBO estimates that the Administration budget would raise the price level by about 1 percent. Further price increases would unfold in later years, as the inflationary consequences of both the stimulus program and the energy program built up.

A comparison of the forecasts by CBO and the Administration of the effect of the President's budget is given in Table 2. The Administration's forecast of 4.7 percent real economic growth from 1977 to 1978 and 4.8 percent growth from 1978 to 1979 is reasonable, but at the high end of the CBO range. The Administration's forecasts of unemployment and inflation are also at the optimistic end of the CBO range.

Other Fiscal Policies

In addition to the Administration proposal, CBO has examined several other possible alternatives to current fiscal policy and estimated their macroeconomic effects. As with CBO's forecast, these projections are on a fourth-quarter to fourth-quarter basis. The illustrative tax measures

examined by CBO include only cuts in personal and business taxes; neither the effects of possible reform measures nor an energy program is included in the policy options presented by CBO. By comparison, the Administration's forecast assumes its proposed energy program would be implemented in the spring of 1978. Inclusion of the Administration's energy program in the fiscal stimulus packages presented below would significantly raise projected inflation and reduce growth somewhat in 1979, according to CBO.

The two alternative projections, shown in Table 3, are based on the following illustrative stimulus packages:

- A $30 billion stimulus package, beginning in October 1978 and consisting of a $24 billion reduction in taxes and a $6 billion increase in spending. The tax cut consists of a $17 billion-a-year reduction in personal income taxes and a $7 billion reduction in business taxes, about equally divided between a retroactive increase in the investment tax credit applicable to equipment and a cut in corporate income tax rates. Unlike the Administration's proposal, no attempt was made to extend the investment tax credit to structures. Spending is increased $2 billion for public-service jobs and $4 billion for various other programs.

- A smaller but earlier $15 billion tax cut, beginning in July 1978, with spending held at current policy levels. The composition of the tax cut is similar to the tax measure described above ($11 billion personal taxes and $4 billion business taxes).

Each stimulus package would increase economic growth in 1979 with some cost in terms of inflation.

TABLE 3. ALTERNATIVE ECONOMIC PROJECTIONS UNDER TWO ILLUSTRATIVE PACKAGES OF FISCAL STIMULUS

Economic Variable	Case 1: $30 Billion Tax Cut and Spending Increase	Case 2: $15 Billion Earlier Tax Cut
	Fourth Quarter of Calendar Year 1978	
GNP(current dollars, percent change) a/	9.9 to 12.0	9.8 to 11.9
GNP (1972 dollars, percent change) a/	4.0 to 5.0	3.9 to 4.9
Unemployment Rate (percent)	5.9 to 6.4	5.9 to 6.4
	Fourth Quarter of Calendar Year 1979	
GNP, current dollars, Percent change a/	9.7 to 12.4	8.9 to 11.6
GNP (1972 dollars, percent change a/	3.8 to 5.3	3.0 to 4.5
Unemployment Rate (percent)	5.4 to 5.9	5.8 to 6.3
	Fourth Quarter of Calendar Year 1980	
Change in Price Level, GNP Deflator (percent)	0.4 to 0.6	0.15 to 0.35

a/ Percent change is percent change from four quarters earlier.

Case 1. The first illustrative package, involving more than $30 billion direct cost, would add about 1.3 percent additional growth during 1979, as compared to the current policy forecast. The unemployment rate would decline to the 5.4 to 5.9 percent range by the end of that year. The impact on inflation would be very small in 1979, but by the end of 1980 the price level would be raised by about 0.5 percent. In terms of direct budgetary effects, this option is close to the Administration's budget proposals. Nevertheless, because the Administration's budget includes somewhat less expansive spending and business tax policies as well as energy measures, the Administration's package would result in considerably higher prices and probably somewhat less real growth.

Case 2. The second package has a small expansive effect in 1978, as the earlier effective date helps to maintain momentum at year-end. It would also have less impact on inflation and real growth during 1979 than the first option. However, by the end of 1979, the effect on output and the unemployment rate is about as strong as with the Administration's proposals (CBO estimate), partly because of the exclusion of the restrictive effects of the energy program. Growth in real GNP is estimated to be about 0.5 percent higher during

1979 than under current policy. The unemployment rate would probably be in the 5.8 to 6.3 percent range in the last quarter of that year. The earlier effective date of this option would require reconsideration of the Second Concurrent Resolution on the Fiscal Year 1978 Budget.

THE LONG-RUN BUDGET OUTLOOK

Mr. Chairman, I also would like to briefly discuss long-run economic goals and budget policy.

The Administration's longer-run budget and economic goals include a balanced budget in 1981, a reduction of unemployment to 4 percent by 1983, and a reduction in the rate of inflation to 4 percent, also by 1983. Those goals are very optimistic. Achieving any one of them will not be easy. Achieving all of them simultaneously appears highly unlikely.

To bring about the desired reduction in unemployment without very large special employment programs, which are not proposed by the Administration and which would present difficulties of their own, might take five years of real economic growth averaging between 4.5 and 5 percent a year. OMB apparently believes these growth rates are consistent

with a decline in the inflation rate to about 4 percent by 1983; CBO estimates that inflation is more likely to remain close to 6 percent if recovery is sustained at this healthy rate. Moreover, even if the nonfederal sectors of the economy grew at rates slightly above their post-World War II average, CBO anticipates that further tax cuts or spending increases after fiscal year 1979 will be necessary to avoid a slowdown in overall growth.

These additional tax cuts or spending increases would jeopardize the goal of a balanced budget. CBO estimates that, unless the performance of the nonfederal sectors is far beyond historical norms, attaining the Administration's announced growth and unemployment targets is likely to require a deficit of around $40 billion to $50 billion in 1981 and to preclude balance until 1983 or later. Indeed, the President himself has suggested in his Economic Report that the Administration's goals might be overly optimistic and that further tax cuts beyond those now proposed might be needed.

CONCLUSION

This is a very difficult time to develop a sound strategy for federal fiscal policy. The economy is suffering from both high unemployment and rapidly rising prices; the risk of an acceleration of inflation or rising unemployment cannot be minimized. If nonfederal demands turn out to be significantly stronger than forecast by CBO, fiscal or monetary stimulus could push the economy toward full employment at too rapid a pace, thereby intensifying existing inflationary pressures. On the other hand, if the momentum of the economy is less than forecast by CBO, in the absence of stimulus, unemployment rates would rise to even higher levels. The budgetary process provides this Committee with the opportunity to review its decisions at the time of the second concurrent resolution, when more information about the economy will be available. Given the high level of uncertainty in the economic outlook, the Committee should be aware that it might want to make adjustments in fiscal policy at that time.